OCTOBER 1960

VOL. XXX NO. 10

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A New Look At the Approach to Auditing

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Cost-Reduction Program

Regular Departments

THE NEW YORK *Certified Public Accountant*

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THE NEW YORK

Certified Public Accountant

October 1960 Volume XXX No. 10

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Accounting News And Trends

MANAGEMENT ACCOUNTING PROBLEMS IN FOREIGN OPERATIONS

With the continued expansion of American business abroad, the NAA Research Report 36, "Management Accounting Problems in Foreign Operations" (March 1, 1960), should have a wide reading public. Of course, the basic techniques of accounting for business transactions are the same regardless of the country in which the business is conducted, but problems arise in applying these techniques to various operations. This study began with an attempt to find out just what these problems were.

The committee that cooperated on this report first surveyed some 51 companies engaged in foreign operations. After a review of the summary of this survey, the committee concluded that the unique accounting problems arise from accounting for transactions in different currencies where stable relationships between these currencies are lacking. Consequently, nearly two-thirds of this 71-page booklet is devoted to this phase of the problem and it is this presentation that will be of most value to those who need specific help in their accounting for foreign operations.

Others may find of greater interest the general description of the accounting problems in foreign operations and the section on reporting to management on foreign operations. For example, these are some of the items cited to show the difference between accepted accounting principles abroad and in the United States:

1. The official recognition of currency inflation and the upward revaluation of fixed assets in some countries. One annual report of a foreign corporation states that profit can only be calculated after the purchasing power of the capital stock and surplus has been maintained, and to achieve this end the replacement value principle is followed.

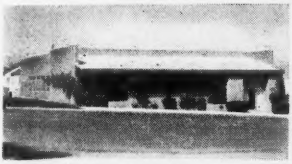
2. Greater conservatism as reflected in more rapid depreciation. Sometimes depreciation rates are so high they distort the financial reports.

3. Use of reserves to equalize profits from year to year. In Sweden, Finland and Denmark, a company is allowed to set up reserves for future inventory declines in an amount up to 60 percent of the yearend inventory. Other countries allow the charge for loss of bad debts to be calculated at 5 percent of credit sales.

Most companies engaged in foreign operations prefer to employ local nationals in accounting positions. The availability of such personnel varies from country to country, but even where the level of financial accounting practice is high, the application of accounting as an internal management tool is seldom as advanced as in the United States. As a consequence, foreign personnel may be inclined to put meticulous accuracy ahead of timeliness in reports and may lack skill in using forecasts, budgets, and standards.

Accounting News and Trends is conducted by CHARLES L. SAVAGE, CPA. He is presently serving as a member of our Society's Committee on Accounting Procedure and is active in the National Association of Accountants. Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College. He is also professor of taxation at the New York Law School.

MARION FEDORA, Chief Accountant and Comptroller.



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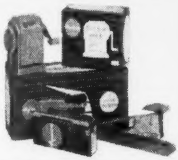

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Marion Fedora
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HISTORY OF A STATE CPA SOCIETY

For those accountants who would enjoy reading a description of how the profession has developed in a particular state, "The History of Florida Institute of Certified Public Accountants and Predecessor Organizations" by Charles C. Potter, will be of interest. On April 19, 1905, the Jacksonville, Florida, newspaper carried an item stating that a meeting would be held that evening to approve articles of association for the Florida Society of Accountants. This appears to be the beginning of organized accounting in the state. Only two accounting firms appeared in the city directory for that year, and these, together with one in Tampa and another one in west Florida, constituted the charter group. Another newspaper item of the same year reports on a suit by an accountant to collect his fee and the jury determined that the services of a well-qualified accountant were worth from $2.50 to $3.50 a day.

The Society was almost immediately successful in having the State Legislature set up a State Board of Accountancy to grant CPA certificates to those who passed the prescribed examinations. This action made Florida the eighth state in the union to pass an accountancy law but it was the first such law in a southern state.

In 1916 the organization was reorganized as the Florida Society of CPAs and by 1924 the number of members was twenty. The Society was incorporated in 1928 as the Florida Institute of Accountants and the name was changed to its present form in 1958.

Some conception of the growth of the profession in Florida can be gained by two items in the report; (1) the total membership reported in 1956 was 811, and (2) more than 300 Florida candidates took the November 1958 CPA examination.

Written in a pleasing style, this 45-page booklet describes the development of a dynamic profession in an expanding state.

READABILITY AND TECHNICAL ARTICLES

In what might be construed as a hint to its contributors, *Systems & Procedures* is running a three-part article by John Seward Fielden on "Writing Readability into Technical Articles" (Part I in May 1960). In recent years much has been written on readability, and formulas for determining it in ordinary material have been developed. In general, these formulas involve those elements of prose which lend themselves to "objective" analysis: sentence length, number of syllables, familiar and unfamiliar words, and personal and impersonal words found per so-many words. Unfortunately, these standards do not apply to technical writing but this does not relieve the writer of seeking to achieve it.

In technical writing, then, readability will not be attained by the hopeful application of any magic formulas, but rather from a thoughtful approach on the part of the writer to every aspect of the technical article. It will result when the writer understands the psychology of the reader, realizes what the reader needs to know, and is aware of how the reader can be led through the labyrinth of the most difficult paper

by exact planning and organization of material. In no event, also, do these suggestions for improving readability in technical articles imply that readability need go hand-in-hand with simplification, in the sense of lowering the intellectual level of a paper on, say, discounted cash flow, so that the man in the street can read it with understanding and interest.

In this article Mr. Fielden confines himself to the introductory elements of a technical paper. These would include all those sections that are designed to help the reader come to the central content of the report with understanding. His analysis indicates that this material falls into seven parts and comments on some of them as follows:

1. *The title*. The writer should seek exactitude and clarity. He should avoid such vague titles as "A Feasibility Study," "Systems Work," or "An Accounting Method." Effort is well spent in finding a title that is descriptive of the article topic but provocative and interesting to the reader. After all, the purpose is to encourage him to begin the article.

2. *The abstract or capsule summary*. This abstract does not try to condense the whole subject matter into a few words, but rather to present to the reader the heart of the subject matter. Since anyone's purpose in writing anything is to communicate his ideas to others, the writer must make the most of the fact that his abstract is aimed at encouraging readers to take up his paper and read it.

3. *The purpose*. Writers of published technical articles are usually well-drilled in giving an early statement of the purpose of their paper. Often, however, the statement of purpose as given reflects more the writer's purpose in conducting the investigation than it does his purpose in publishing his work. Both are, of course, necessary. It is one thing to state that one's purpose is to investigate the speed of an electronic data processing machine; it is another thing entirely to communicate these findings to a reader and to show him why this matter of speed is important to him.

COST REDUCTION AND COST CONTROL

After considering budgeting and financial planning, the AICPA now offers bulletin 4 of the series *Management Services by CPAs,* entitled "Cost Reduction and Cost Control in the Small Business." ($10.00 for the series of 5 bulletins; $3.50 each.) Since the profit margins of businesses have been steadily declining, the ultimate survival of small business will depend in part upon its readiness to adopt the techniques of modern management. This bulletin confines itself to two of the elements of cost control: the development of formal cost reduction programs; and the use of cost analysis. Both have considerable value for a high percentage of small businesses. Both also involve techniques which are already familiar to most CPAs or in which they may become competent quickly.

The orientation section of this bulletin is concerned with the basic principles underlying a formal cost reduction program, the benefits to be derived from it, and the approaches to be used in establishing it in a small business.

The values and other end results of using cost analysis in the management of the small business is the purpose of the illustrative material. These illustrations provide coverage of distribution cost analysis and direct variable product cost analysis.

The final section of the bulletin provides reference or study material in the areas of cost reduction, cost accounting, distribution cost accounting and cost analysis techniques.

Letters to the Editor

VARIATIONS IN STATEMENT PRESENTATION OF REAL ESTATE COMPANIES

Statement presentation of accounting information for real estate companies should, as in any other type of business, be prepared with sufficient clarity so that the reader is enabled to comprehend the results of operations and financial position. This is especially true of syndications and other real estate enterprises since the average investor probably has little experience in real estate matters. The readers of *The New York Certified Public Accountant* may find of interest the following discussion of certain features of statement presentation which some accountants have found to be useful for more informative reporting.

Several variations have been introduced in the statement of income, one of which is the allocation of expenses between fixed expenses and variable expenses or those that can be controlled. Another is the segregation of non-cash expenses such as depreciation, whereby these items are deducted from an income balance to arrive at the net income.

There is also a trend among some accountants to adjust the statement of income even further, so as to accurately reflect the investor's view of income. Normally, the investor considers depreciation as an arbitrary and possibly a fictitious figure, used only for income tax purposes, and he substitutes instead the amortization paid on mortgages. Non-cash expenses that are amortized, such as mortgage costs and leasing commissions, are viewed as being expended in their initial year and are not expenses of the ensuing periods. On the other hand, expenditures made for improvements or for amortization of loans by which improvements were financed, are regarded as expenses. Payments to a reserve account to cover major replacements on an FHA controlled project are also considered an expense by the investor since it comes out of his pocket. Basically, the investor in a syndicated group or an owner of real property held for income is primarily interested in his net return on capital. Capital represents his investment. Net return is the amount remaining after all cash expenditures are made, or, in the case of the syndication, the amount that is distributed to him from this excess. If the results of operations are viewed in this manner by the laity as well as by those familiar with real estate operations, there is no reason why the accounting statements prepared by an accountant should not properly reflect this attitude.

One method of doing so is to prepare a separate schedule or exhibit which will reflect "net return." Several descriptions have been given to this presentation among which are, "Net Return," "Net Return on Investment," "Cash Return," "Economic Statement of Income," and "Cash Results of Operations." This net return statement (as I shall refer to it) usually starts with the net income as reflected in the statement of income, and adjustments are made by adding back the depreciation and other non-cash items and subtracting the amortization of mortgages and other expenditures which might enter the balance sheet accounts but reduce available cash. Adjustments for prepayments and accruals are cumbersome and to do so might complicate the presentation. It is quite possible that the opening and

closing accruals might offset themselves so that the problem would be obviated. The remaining figure, after all adjustments, represents the net return. The statement should also reflect the investment or capital contribution. In the case of a corporation it would include indebtedness to stockholders. The investment should be adjusted for additional net capital contributions and excesses of net returns over amounts distributed in prior years. By dividing the adjusted investment into the net return, the rate of return is arrived at. It also might be useful to obtain the rate of return before deducting the amortization on mortgages since the amortization paid increases the equity in the property.

If the accountant wishes to avoid preparing two statements of income, first the normal statement of operations, and secondly the adjusted statement reflecting net return, it is possible to present only one statement of income and adjust it so as to arrive at the net return. Furthermore, the statement of income might be prepared by excluding the depreciation entirely and including the amortization of mortgages as expenses. The surplus section would then be adjusted to reflect the correct accounting income.

Ramifications of net return presentation are numerous. In the case of a corporation that pays salaries to its officers, would adjusted net income or net return include the salary or would it be added back to income? How about income taxes? Does the investor calculate his rate of return before or after taxes?

An assumption must be made that the reader thoroughly understands that the net return, or percentage of net return, is based upon capital invested and not appraised values. Consider the following situation. An individual has $100,000 invested in a real estate company or syndicate which gives him a net return of $10,000 per year or 10

percent on his investment. The real estate has appreciated a great deal and, if sold, the investor would realize a profit of $300,000 after income taxes. Assume that the investor can reinvest the $400,000 net proceeds in another investment which would yield 8 percent or $32,000. In such a situation is he actually making $10,000 per year on his original capital or is he losing $22,000 a year by not reinvesting? Of course this particular observation would hold true for any type of investment and is not restricted to real estate alone.

Variations in balance sheet presentation of real estate companies are by no means extensive, but yet are worth discussing. There is a difference of opinion as to whether or not the fixed assets should appear before current assets. Since the real estate itself is of prime importance, and there usually are sufficient funds to meet all current liabilities (assuming that operations are profitable), there is no reason why the fixed assets shouldn't appear first. However, many accountants still prefer the traditional approach.

Previously I mentioned the possibility of presenting depreciation as a segregated item on the income statement. The same principle can apply to the statement of financial position. The accumulated depreciation instead of being deducted from the fixed assets would be subtracted from the net worth comprising gross assets less liabilities. The use of net worth before depreciation is especially desirable in comparative statements of financial position, since the excess of net worth, before accumulated depreciation, over the prior year's net worth is clearly shown. In the case of an entity other than a corporation, this increase in equity would normally represent the amount of amortization paid on the mortgages plus any undrawn net income before depreciation. In the case of the corporation, the increase in equity would represent amortization of mortgages, undrawn profits before depreciation, plus the reduction in stockholders' indebtedness assuming that it is included in the liabilities.

To carry the discussion on net worth still further, consider the useful presentation of obligations due stockholders, the proceeds of which, together with the capital contribution, were used to acquire the real estate. The breakdown between capital stock and indebtedness is accomplished mainly for income tax purposes. The investor, however, still views his capital as consisting of the total amount invested, whether it be in stock, notes, or bonds. To meet his viewpoint, the indebtedness to stockholders can be eliminated from the liability section and a net worth arrived at by subtracting liabilities from gross assets. The indebtedness to stockholders can then be deducted from the resulting figure to arrive at a net worth before accumulated depreciation, followed by the deduction for the depreciation to date. The segregation of stockholders' indebtedness and accumulated depreciation is best accomplished in the "running form" type of financial position whereby the liabilities are subtracted from the assets to arrive at the capital section.

Probably there are many arguments against following any of the abovementioned variations. However, when an accountant sits down and reviews a statement with his client, many of the arguments seem to disappear. As accountants we must not forget that clarity in our reports is essential. If we prepare reports reflecting results and financial positions in a manner to which the reader is accustomed, then we have accomplished a great deal. If instead we follow supposed traditional accounting procedures in presentation that are not traditional to the

layman, then have we accomplished one of our major objectives—the preparation of informative statements.

CHARLES F. VENGROVE, CPA
(*Vengrove, Shapiro & Co.*)
New York, N. Y.

EMPLOYEE BENEFIT PLANS—SOME ACCOUNTING AND AUDITING PROBLEMS

As a member of our Society's Committee on Employee Benefit Plans, I was recently asked to answer an inquiry made to the Committee by a member of the Society. Since the items discussed cover a variety of problems peculiar to employee benefit plans, and since this is becoming a wider field of accounting, because of the recent passage of federal and state legislation, it was suggested that I forward the enclosed information to you for possible publication in the "Letters to the Editor" department. I am therefore enclosing a copy of the original letter of inquiry to the Committee, and a copy of my reply.

Letter of Inquiry

I hope the Committee on Employee Benefit Funds will indicate its preferred treatment of the following matters:

1. Accounting treatment of the discount or premium on bond purchases.

2. Accounting treatment of the sale of stock rights.

3. Accounting treatment of the sale of fractional stock dividends.

4. Classification of deposits in savings banks, federal savings and loan associations and time deposits in commercial banks. Should any of these deposits be classified as cash in bank or as investments. If investment fees are based on value of investments, would any of the above items enter into the base on which the investment fee is calculated?

5. What is the extent of the auditor's duties in connection with the sale

and purchase of securities by the bank acting as purchaser and custodian of the securities?

6. What auditing procedures does the Committee recommend in connection with payments made directly by the Blue Cross for members of a welfare fund, where the amount of premium is ultimately determined by the aggregate payments made by Blue Cross plus a handling charge?

For information purposes I am submitting the following copy of a letter which refers to a comment of the Banking Department of the State of New York. This is pertinent to item 1, above.

"The Banking Department of the State of New York has completed its audit of the above fund for which you are the accountants. In its covering letter as well as in its report the Banking Department pointed out that the inventory values on the fund's books differ from those of the corporate trustee. This has arisen because the trustee bank stopped amortizing premiums on bond purchases and restored previous amortization in 1956. Also on the sale of stock rights the bank considers the entire proceeds as profits. On the other hand, the fund amortizes premiums on bonds which the bank had been amortizing but does not amortize on bonds purchased, does not write up discounts and allocates costs on stock rights.

"The Banking Department suggests that the inventory figures of the fund and of the trustee bank be brought into agreement.

"The committee has instructed us to advise you that it desires that you take the necessary action to accomplish this."

Letter of Response

Your letter relative to the auditing and accounting for certain transactions common to Employee Benefit Plans, has been referred to me for reply. As Mr. Isidore Platkin, chairman of

our Society's Committee on Employee Benefit Plans, has previously informed you, the controversial nature of some of the issues raised has necessitated a thorough discussion by the Committee. I have attempted, in answering your questions, to reflect the thinking of the majority of the Committee, based upon their own experiences in handling these problems. However, the opinions expressed in this letter do not represent the opinion either of the State Society or of any firm represented in the membership of the Committee on Employee Benefit Plans.

1. *Accounting Treatment of the Discount or Premium on Bond Purchases*

Let me say, at the outset, that the only completely proper method of reporting investment income is by adjusting for premiums and discounts. The Committee is aware, however, that the majority of banks in the New York area have, since 1956, stopped amortizing premiums and accumulating discounts in their reports to fund trustees. Their reasons, as stated in letters to several trust funds, were that the difference in income, annually, was so infinitesimally small, in most cases, that there would be no material misstatement of income. The majority of the Committee is inclined to agree that, where the difference is immaterial, in the auditor's opinion, it is practical, advantageous and acceptable to eliminate adjustments for premiums and discounts, and carry bond investments at cost.

In the case you cite, where the State Banking Department has instructed that the inventory figures of the fund and the trustee bank be brought into agreement, we feel this should be done in your report to them.

However, in cases where the auditor believes this would result in a material misstatement of income, he should include, in his audit report, a reconciliation between the inventory and investment income shown on the bank's report and the figures shown on his own report, so as to avoid confusion in the minds of the trustees.

2. *Accounting Treatment of the Sale of Stock Rights*

Many of the comments stated above apply in the treatment of stock rights. Where immaterial, the auditor's report should be in agreement with the report of the bank trustee, as must the report to the State Insurance and Banking Departments. In the case of the fund you cite, the bank considers the entire proceeds from sales of stock rights as profits. Some of the banks treat the sale of stock rights as a reduction of inventory. We believe both methods are acceptable. Again, we wish to emphasize that where the auditor feels that the difference between the above methods and the more correct method of allocating costs is material, he should include in his audit report a reconciliation between the bank's figures for inventory and income, and his own report figures.

3. *Accounting Treatment of the Sale of Fractional Stock Dividends*

The thinking of the Committee is the same as above. Most banks treat this as a reduction in inventory value. Again, if the auditor feels there is a material misstatement involved, he should include a reconciliation in his audit report.

4. *Classification of Deposits in Savings Banks, Savings and Loan Associations, and Time Deposits in Commercial Banks*

The Insurance and Banking Departments will now accept the thinking of the Federal Government in this respect. The federal Form D-2, in the instructions for the preparation of Exhibit B-1, states that shares in savings and loan associations are to be included in cash, rather than investments. Since this has long been the thinking of our Committee, and since both state de-

partments will now accept this, we believe this is the preferable treatment.

As to your question concerning the basis of investment fees charged by the bank, I feel this is strictly a matter of the agreement between the trust fund and the bank.

5. *Extent of Auditor's Duties in Connection with Sale and Purchase of Securities by a Bank Acting as Purchaser and Custodian*

Your letter is not entirely clear as to whether the bank, acting as a trustee, has the power to make purchases and sales without prior approval, or whether the bank merely acts in an advisory capacity and can execute purchase and sales orders only after prior approval of the trustees. Since you state that the bank acts as purchaser and custodian, we will assume the latter. The Committee recommends the following audit steps:

(a) The first and basic step is to determine that the trustees are investing the funds in accordance with the terms of the trust agreement, as interpreted by counsel to the plan, where appropriate.

(b) The approval of the trustees for each purchase and sale of securities should be ascertained by reference to the minutes of trustees' meetings and by copies of letters of approval from the trustees to the bank.

(c) These purchase and sales orders should be checked against the bank's statements, and the plan's portfolio, as shown by the books of account. The mathematical accuracy of the purchases and sales orders, and the prices, should be test checked.

(d) Direct confirmation of securities held by the bank, as custodian, should be made.

Since you ask only about the purchase and sale of securities, we are not here discussing the audit of investment income.

We wish to refer you to an article, cited below, by a member of our Committee, Raymond Buchbinder. On page 103, you will find a most helpful discussion of investments.

6. *Auditing Procedures in Connection with Claims Paid by Blue Cross*

Since the premium paid is directly dependent on the aggregate amount of payments made by Blue Cross, it is obvious that the auditor must make a test check of the claims paid.

Monthly, Blue Cross sends to the fund office a "Paid Claims Register," which shows the claims paid during the month to each patient. A total of claims paid is also shown. This Register forms the basis of any adjustments by Blue Cross during the year.

Proper tests would include a check of this claims register against the fund's eligibility records, to ascertain the patient's eligibility at the time his claim was paid. An additional check might be made of the employer's reporting forms to ascertain if the claimant was reported as working during the period of the claim.

As a general rule, the extent of the test check will, of course, depend upon the accuracy of the fund's claims and eligibility records, and the number of errors found in prior years.

Two excellent references regarding the audit of claim payments, while not directly referring to Blue Cross, may be of help to you. They are:

(a) "Union Welfare Funds," Raymond Buchbinder, *The New York Certified Public Accountant,* February 1958.

(b) "Case Study on Audit of a Self-Administered Union—Industry Welfare Fund," by the Committee on Labor Union and Welfare Funds of the American Institute of CPAs.

STANLEY I. BERLAND, CPA
New York, N. Y.

THE PRESIDENT'S PAGE

Change in Editorship

TRIBUTE TO
PROFESSOR BENJAMIN NEWMAN, CPA

With this issue Professor Benjamin Newman leaves us, after four years as Managing Editor of *The New York Certified Public Accountant,* to devote more of his time to writing and teaching—fields in which he has become pre-eminent. Ben came to us in the fall of 1956 to edit a magazine which had attained such high standards under Dr. Emanuel Saxe as to have earned national and international recognition in the accounting and publishing fields. Ben very ably maintained these high standards and brought new honors and distinction to our publication for the high quality of material and format.

He also took over the position of our Society's Director of Technical Services and Research, likewise an important function inasmuch as it deals with requests from members for direct assistance. In this area, too, Ben contributed with distinction in serving our members.

No one who does not get behind the scenes can adequately evaluate the Editor's job. To turn out a well-balanced magazine that will meet the needs of diverse categories of members and subscribers, to keep it abreast of the times in a rapidly progressing period, and to get it out on schedule each month—this is truly a great achievement particularly in view of Ben's concurrent full-time professorial post on the faculty of the accounting department of the School of Commerce, Accounts and Finance, New York University. From my personal

observation, I know how much painstaking effort has been devoted by Ben to encouraging authors and assisting them in completing and perfecting their writings. His sterling character and loyalty would never permit him to count the hours he felt were necessary to maintain and improve the magazine.

We will miss Ben not only as Editor of the magazine but also as our Director of Technical Services in which capacity he was always a patient listener, ready to supply from his broad experience the answers to the knotty problems presented to him. He leaves with our sincerest and best wishes and our heartfelt appreciation for an assignment filled even beyond all of our expectations. We have every confidence that accounting literature and education will continue to benefit for many years to come as a result of the broad outlook and stature which Ben has attained and his devotion to the CPA and teaching professions. Fortunately, as a member of our Society Ben can continue to be active in our ranks and afford us the benefit of his wisdom and experience.

OUR NEW EDITOR — MAX BLOCK, CPA

We are fortunate to have obtained Max Block, CPA, as our new Managing Editor commencing with the November issue. All of us have known Max for many years because of the numerous positions he has held in our Society. He has served as chairman and member of the Committee on Publications; he initiated and conducted for almost ten years the magazine department "Administration of a CPA Practice"; and he has written extensively for accounting and other magazines. He is a lecturer at the Graduate School of the Bernard M. Baruch School of Business and Public Administration of The City College of New York and has lectured extensively to accounting and other groups. Max has by no means retired from public accounting. He has reduced his active time with his firm and will devote his free time to our Society.

Max also brings to us the high character and qualities necessary to maintain and even improve both *The New York Certified Public Accountant* and the Technical Services Department. In parting with Ben Newman, with keen regret and very deep appreciation, we are comforted by the thought that Max will take over. He should be a worthy successor to his distinguished predecessors.

BENJAMIN GRUND,
President

A ROLL OF HONOR

After four years of service as Managing Editor of *The New York Certified Public Accountant* and as our Society's Director of Technical Services and Research, it is not easy to say farewell to those many CPAs—authors, departmental editors, chairmen and members of the Committee on Publications, Society officers, committee chairmen, the distinguished Editor who preceded me, and members of our Society and of our profession—whose dedicated efforts and splendid cooperation enabled me to pursue with confidence the objectives associated with my functions. I wish it were practicable to list, as an expression of profound appreciation, the names of all who contributed so altruistically and so heavily of their time and talents. It would be a true roll of honor reflecting the depth of my farewell sentiments and matching the exalted stature of our CPA profession.

BENJAMIN NEWMAN

A New Look At the Approach to Auditing

By Reed L. Colegrove, CPA

A number of generally accepted auditing procedures and techniques are subjected to a critical review and appraisal, giving consideration to the significance of internal control and to the auditor's responsibility for fraud detection in determining the scope of an examination. In evaluating certain traditional auditing procedures the author questions whether they are all appropriate as to timing and scope in every examination and whether some of them are applicable at all on some engagements.

The standard short-form audit certificate is achieving steadily increasing public recognition as a hallmark of acceptability. To the reader of financial statements it represents assurance that the data included in the statements are fairly presented in conformity with generally accepted accounting principles applied on a consistent basis. While the layman may not be conversant with generally accepted accounting principles or fully aware of the significance of their consistent application, he can appreciate the assurance that the examination was made "in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures" as the auditor considered necessary in the circumstances. The auditor's opinion in such a report therefore invites reliance by his client and by third parties on the proper application of generally accepted auditing procedures. This is an assumption which every independent auditor should, of course, be prepared to support and justify. In this connection it may therefore be in order for independent public accountants to undertake, from time to time, a review and appraisal of current auditing techniques and to consider whether such techniques are in fact "necessary in the circumstances" and are being properly applied.

There is a suspicion on the part of the writer that the scope of some audit examinations may be determined in the wrong perspective and with an unrealistic objective, and that sometimes there is a tendency to rely on the "tried and true" techniques which have long set the pattern for the usual examination incident to the expression of an opinion on the financial statements. I have in mind such auditing procedures as the following, some or all of which are included in many examinations today: petty cash counts on a "surprise" basis; independent year-end bank reconciliations;

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the timing of receivable confirmation and physical inventory observation as of a date convenient to the auditor, or perhaps to the client; vouching of all major additions to fixed assets and of all major charges to repairs and maintenance; footing of the year-end trial balance of trade payables and vouching or confirming larger balances; reviewing cash transactions in detail for a selected interim period which may vary from a month to three to six months, or even to a year if the number of transactions is small. These procedures may represent sound auditing techniques in and of themselves; it is hardly likely, however, that they will all be appropriate as to timing and scope in every examination, and in fact some of them may not be applicable at all on some engagements.

THE IMPORTANCE OF REVIEWING INTERNAL CONTROL

It is generally understood that it is not possible to design a standard audit program which can be followed in every engagement. The scope of each examination must of necessity be determined in the light of circumstances as they existed during the period covered by the examination and at the time of the audit. These circumstances can only be assessed intelligently by making a review of the client's accounting procedures and internal control prior to commencing the examination, and continuing such review during the examination. Obviously, auditing procedures applicable in a situation where internal control and accounting procedures appear to be good should vary markedly from those procedures applicable where the accounting procedures and control are poor. It is therefore imperative that a review and appraisal of internal control precede the tentative determination of the scope of the auditor's examination. This concept is given formal recognition in the second of the Standards of Field Work which states that: "There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted."

Internal control is a broad, general (and frequently overworked) term relating to all facets of a company's operations. It is perhaps easier to define, and to relate to the responsibility of the independent auditor, if it is classified into three areas: internal administrative control, internal accounting control, and internal check.

Internal administrative control comprises the organization measures adopted within a business to promote operational efficiency and encourage adherence to prescribed managerial policies. For example, time and motion studies, quality control and comparison shopping are controls designed to achieve these objectives. Such controls usually originate in and are conducted by operating departments other than financial or accounting, and in most instances will not be of primary concern to the auditor.

Internal accounting control comprises those controls which are designed to bring about accurate and suitable recording and summarization of authorized financial transactions (that is, controls which ensure the accuracy and reliability of accounting data). Double entry bookkeeping, for example, is internal accounting control in one of its simplest forms. Other examples include controlling accounts for receivables, payables, and inventories; periodic trial balances; reconciliation of book balances with outside sources (bank reconciliations) or physical counts; prenumbering documents (checks, sales invoices, pur-

chase orders, etc.) and accounting for all numbers to ascertain that all data have been recorded; and checking the accuracy of postings, footings or computations, either by the person preparing the data or by a second person. Each of these procedures is designed, in part at least, to ensure the proper recording of transactions.

Internal check may be described as those controls which are designed to safeguard assets against defalcations or other similar irregularities. This type of control would include such measures as separating the functions of custodianship and record-keeping, independent surprise counts of cash and securities, and plant security procedures relating to the physical movement of inventory and fixed assets.

The scope of the independent auditor's examination must of necessity be determined in large measure by the adequacy of his client's internal accounting control and internal check. However, internal accounting control will have its principal influence on the volume and extent of the work to be done, while internal check will primarily affect the timing of audit procedures with a somewhat lesser influence on the extent of the work. For example, more independent testing of inventory extensions and footings would be required where the inventory was manually extended and footed and such extensions and footings were not checked by the client's personnel (poor internal accounting control) than in the case where the inventory was listed by a machine providing automatic totals, or where the manually prepared inventory was double checked. On the other hand, poor physical control of inventory (poor internal check) would probably require the observation of physical inventory-taking by the independent auditor at the balance sheet date rather than at an interim date. By the same token, if accounts receivable are under the direct control of the credit manager, or if bank statements are reconciled by the cashier, the confirmation of receivables and independent reconciliation of bank accounts by the outside auditor should probably also be done as of the balance sheet date to establish the integrity of the balances on which his opinion is being expressed.

RESPONSIBILITY FOR FRAUD DETECTION

In addition to the necessity for reviewing and assessing the client's internal control, in the opinion of this writer a second and equally important premise must be accepted in determining the scope of the independent auditor's examination. This premise relates to the limitation on the auditor's responsibility for the detection of fraud in the ordinary examination leading to the expression of an opinion on financial statements. *Codification of Statements on Auditing Procedure,* issued by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants, states that: "The primary purpose of an examination of financial statements by an independent certified public accountant is to enable him to express an opinion as to the fairness of the statements, their compliance with generally accepted accounting principles, and the consistency of the application of those principles with that of the preceding period. . . . The ordinary examination incident to the issuance of an opinion respecting financial statements is not designed and cannot be relied upon to disclose defalcations and other similar irregularities, although their discovery frequently results." While the independent auditor must be aware of the possibility of fraud, his concern should,

I believe, relate to the effect which the existence of fraud may have upon his opinion on the fairness of the presentation of the financial statements. As *Codification* indicates, he cannot design the ordinary examination primarily or specifically to discover fraud.

As a practical matter this disclaimer of responsibility for fraud detection is completely logical. Let us assume, for the moment, that a client is willing to pay the prohibitive cost of a complete audit of all transactions on the basis that the auditor will provide a guarantee in his audit report that there were no defalcations or similar irregularities during the period under review. The scope of the auditor's examination will accordingly be enlarged to cover every transaction recorded in the books. Is he now in a position to underwrite the insurance against fraud? Patently, he is not. He has no assurance that all transactions have been recorded or that the supporting documents he has examined are not spurious, nor can he be certain that there has not been collusive fraud by his client's personnel. The auditor has therefore done everything he is professionally competent to do and still cannot guarantee the absence of fraud. Admitting that the cost of a detailed audit operates as a practical deterrent to such an examination, there are those who feel that an auditor should assume the responsibility for making sufficient tests so that he can represent to his client with reasonable assurance that there have been no defalcations or other irregularities during the period under review. The question then becomes—how responsible, how much testing, and how much assurance? Is the auditor who examines the details of two months' cash transactions twice as assured as the auditor who confines his examination to one month? If so, shouldn't he examine six months' transactions so that he can feel six times as confident? But if he does this he will still be only half as confident as the man who examines transactions for the entire year. Yet we have seen that even in this instance there is still no guarantee of the absence of fraud. The answer is, that for the auditor who assumes a responsibility to his client for the detection of fraud in an ordinary examination leading to the expression of an opinion on the financial statements, there is no limit beyond which he need not go in fixing the scope of his examination. There is no magic formula which will permit him and his client to sleep nights, secure in the knowledge that nothing is wrong.

What, then, is the role of the independent auditor in the prevention, detection and elimination of fraud or the possibility of fraud? While he cannot act as a guarantor or insurer against fraud he must, as I previously stated, certainly be aware of the possibility of its existence, and he should be particularly concerned with the possible effect of fraud on the integrity of amounts in the balance sheet on which he is expressing an opinion. If his procedural tests disclose circumstances which suggest the presence of fraud he should call the matter to the attention of his client and indicate all of the attendant possibilities, including the fact that, if the defalcation is material, he may be precluded from expressing an opinion on the statements until the amount of the loss involved is determined to his satisfaction and is properly recorded in the accounts. The significant point is that responsibility for the prevention and detection of fraud rests with the client, and should be accomplished through the maintenance of adequate accounting records and

through appropriate internal control. While the independent auditor must be aware of the possibility of fraud he is not an insurer or guarantor against its existence, and if his examination has been made with due professional skill and care he has fulfilled all of the obligations implicit in his engagement.

Acceptance of the premise that there is a definite limitation on the auditor's responsibility for the detection of fraud has a significant effect on the scope of his examination. It is my opinion that certain procedures followed by some auditors, including surprise cash counts, surprise security counts, and the witnessing of payoffs, are designed primarily for the detection of fraud, and as such are probably not necessary in the usual examination leading to the expression of an opinion on the financial statements. However, the auditor does have a responsibility for advising his clients of weaknesses in internal check where such weaknesses come to light during his review of internal control. Testing required to evaluate internal check procedures is properly includible in the audit program. The important distinction is that such tests should be designed primarily to evaluate procedures rather than specifically for the detection of fraud. In this connection it should be noted that most procedural testing is done in connection with internal accounting controls rather than internal check.

It is quite possible that some clients may object to the elimination from the audit program of certain audit steps which the auditor may feel are primarily for the detection of fraud and are therefore not necessary in the usual examination. It is suggested that such clients be tactfully advised that they are paying for "extras" not requisite to the expression of an opinion on the financial statements. Most CPAs are glad to provide any extra service which the client wishes to buy, but the fact that such service is not included in the "standard audit contract" should be clearly understood by the client.

APPRAISAL OF SPECIFIC AUDIT PROCEDURES

It may be appropriate at this point to review and appraise some of the more generally accepted auditing procedures, giving consideration to the following questions: Is the procedure necessary at all? Could the same conclusion be reached with less work or with a different approach (that is, is there a more practicable substitute)? Is the procedure designed to evaluate the client's internal control or is it designed primarily to detect fraud? Is the timing of the work proper in the light of existing internal check? The conclusions reached in the discussion which follows reflect the writer's opinion that (1) an audit cannot be intelligently undertaken without an adequate understanding of the client's accounting procedures and internal control; (2) considerable emphasis should be placed on procedural testing designed to evaluate these procedures and controls; and (3) a very definite understanding should exist between the auditor and his client as to the limitation of the auditor's responsibility for the detection of fraud or other similar irregularities.

CASH

Unless the auditor is specifically requested to do so by his client (that is, as an "extra" outside the scope of his regular examination), it should not ordinarily be necessary to count petty cash on hand. Internal accounting controls and internal check relating to such cash can be evaluated by discussion with the client and by the examination of petty cash vouchers and other supporting data. Counting of cash does not in itself assist in this evaluation; counting

is done primarily for the possible discovery of a shortage (that is, the detection of fraud). If the auditor feels it is necessary to count cash on hand because of its materiality, then presumably his count should be made at the balance sheet date. In this connection, the counting of undeposited receipts can be avoided by controlling such funds until they are deposited and obtaining an authenticated duplicate deposit slip. This, in conjunction with obtaining an independent cut-off bank statement which would disclose the charge-back of bad checks, should effectively establish the integrity of the amount deposited.

Audit procedures applicable to the examination of general bank accounts should be primarily dependent upon the client's internal accounting control and internal check. If these controls are deficient the auditor may feel that he must make an independent year-end reconciliation of all general bank accounts, with an appropriate follow-up of reconciling items. If internal control is satisfactory, year-end work can generally be limited to obtaining bank statements directly from the bank for a cut-off period subsequent to the year-end for the purpose of checking year-end reconciling items, to proving the arithmetical accuracy of the client's year-end reconciliations, and to checking interbank transfers. In connection with the examination of general bank accounts for an interim period it may be satisfactory to work with the client's reconciliations if certain additional steps are followed, such as the examination of bank cancellation dates on checks. However, it will generally be quicker to obtain cut-off statements directly from the bank for a short period and to prepare independent reconciliations and proofs of cash (such proofs comprising a reconciliation of receipts and disbursements per books with receipts and disbursements per bank during the cut-off period). Interim cash work is primarily a test of the client's cash procedures and controls, and it should not be necessary to include all general bank accounts in such an interim review. Where the client's procedures for all bank accounts are similar, such procedures can be evaluated as effectively by working with one account as with ten. By the same token it should be possible to evaluate procedures as readily by testing transactions for a few days or a week as by reviewing an entire month, as is sometimes done.

In most instances an independent reconciliation and proof of cash of imprest balance and "one-way" bank accounts will probably not be necessary. Because of the immateriality of the book balances of imprest accounts and the specialized nature of and attendant internal control over "one-way" accounts, the auditor's examination can generally be limited to an interim review of the client's procedures and controls, possibly integrated with vouching and procedural tests of payroll. With respect to "one-way" accounts this review should include the checking of bank transfers, the timing of the audit tests being dependent on the degree of adequacy of the client's internal check. Bank balances of imprest balances and "one-way" accounts should be confirmed at the year-end and confirmations should be traced to the client's year-end reconciliations. Wherever possible, internal auditors should be encouraged to make at least one of their reconciliations of these accounts at the balance sheet date.

The following additional observations are, I believe, pertinent to several other frequently followed cash audit procedures. Obtaining duplicate deposit slips from banks as a test for lapping is not a practical audit procedure since, except in rare instances,

banks do not check the details of deposits. Checks outstanding and uncleared as of the prior year's balance sheet date should not be examined in the subsequent audit; any question as to such items should have been cleared by the examination of supporting data prior to the issuance of an opinion. It is an unnecessary expenditure of time for the auditor to write check numbers on outstanding check lists or to indicate subsequent clearance of checks on his outstanding lists; he should work directly with the client's records and list only those items remaining uncleared which require follow-up. Checks drawn to cash or to employees should not be scheduled for follow-up; such items should be reviewed in connection with the voucher test. It is not necessary to examine endorsements on checks in connection with a bank reconciliation or a proof of cash incident to a review of cash procedures, unless the client performs this step and the auditor's examination is undertaken to test compliance with his client's internal check procedure. However, endorsements should be examined when the examination of checks is made in connection with a test of supporting data for cash disbursements, because in this case the review of procedures will not be complete unless each step of the transaction, including endorsement by the payee, is included in the test.

RECEIVABLES AND PREPAID EXPENSES

When receivables are confirmed at an interim date (which is an acceptable practice except when internal control, and particularly internal check, is not satisfactory), further confirmation should be necessary at the year-end only in very rare cases, such as the existence of extraordinarily large balances, a radically different mix of accounts or unsatisfactory results from interim confirmation requests. Checking (either footing or tracing balances to detailed records) of year-end trial balances should not generally be necessary if such tests were performed at the interim date. Year-end work under these circumstances can usually be limited to a review of transactions subsequent to the confirmation date, and to the investigation of unusual fluctuations or postings from other than normal sources.

The use of positive confirmation requests should be limited to unusual circumstances, such as balances of outstanding materiality, a few large customers, or balances in dispute.

A question occasionally arises as to the definition of the "rare" circumstances under which it is permissible for the auditor to use alternate procedures in lieu of confirmation. Generally, accounts with the U. S. Government cannot be confirmed (although recent experience indicates that where sufficient detail is furnished confirmations can be obtained from some government sources). When no reply has been received to a positive confirmation request or when a reply indicates inability to confirm, and in certain instances when a client's request that no confirmation be sent is deemed valid, alternate procedures may also be acceptable. When alternate procedures are determined to be appropriate the mere tracing of collections to the cash receipts book is not conclusive evidence of the existence of the asset; tracing cash receipts should be supplemented with an examination of other data substantiating the receivables, such as shipping documents, remittance advices or correspondence files.

The determination of a reasonable sample of accounts to confirm can only be made in the light of circumstances existing in each engagement, based on such factors as the total number of accounts, the average dollar balance of

accounts, the extent of internal audit confirmation, and the adequacy of the client's internal control. It is unrealistic for an auditor to attempt to establish a formula for determining the number of accounts to be confirmed which can be applied in every engagement.

In most instances the auditor should be able to rely on client personnel to follow up routine differences disclosed by confirmation replies, provided such personnel are independent of functions relating to accounts receivable. In this connection it does not seem necessary to schedule such differences if they are of a minor or routine nature.

In connection with the examination of prepaid insurance, audit time can frequently be reduced by testing transactions directly from the client's insurance register when one is maintained, scheduling only a summary by types of coverage and related prepaid amounts. When the client does not keep an insurance register, the details of larger prepaid amounts only should be scheduled for testing. By the same token it does not seem necessary to examine all insurance policies in force.

INVENTORIES

There are several comments which I believe are pertinent to procedures followed by the independent auditor in his observation of physical inventory-taking. The auditor's primary objective in this connection should not be to accumulate a large volume of his own test counts, but to ascertain that his client is taking an accurate and complete inventory. In other words, test counting should be placed in its proper perspective as a tool for evaluating the client's procedures. The auditor who concentrates on filling his working papers with test counts may very well lose sight of the overall picture. In this connection it should rarely be necessary for the independent auditor to control inventory tags. Rather, he should ascertain that provision has been made for adequate control by the client's personnel, and his test should comprise an examination of control records for compliance with procedures established.

In his review of inventory pricing and cost records the auditor should work directly with the client's records wherever possible, and should avoid accumulating a great mass of schedules in his own working papers.

Techniques of testing extensions and footings of inventory summaries can be improved in many cases. Sight testing can be employed to good advantage in most footing tests as well as in testing extensions. Too much importance is frequently placed on checking the precise accuracy of the client's computations; generally it should be satisfactory to approximate the client's balances by sight testing. Since the misplaced decimal is the most frequent cause of extension errors, this problem should be emphasized in extension tests.

When physical inventories taken and priced by the client are tested by the auditor at an interim date (which presumes satisfaction with existing internal check and internal accounting control), his year-end work can generally be limited to (a) a review of transactions from the inventory date to the balance sheet date for unusual fluctuations or postings from other than normal sources, (b) a comparison on a test basis of unit costs at year-end with those tested at an interim date, (c) a review of gross profit percentages during the intervening period, and (d) a review of the relationship of selling prices at the interim date with those at the year-end. Most of this can be done by working directly with the client's records, and the working papers need include only a write-up of work done and comments thereon.

FIXED ASSETS

It is my opinion that the procedural testing approach is just as applicable in the examination of fixed assets as in any other phase of the audit work. Too often an auditor is prone to feel that it is necessary to vouch all major fixed asset additions during the year, regardless of the effectiveness of the client's accounting procedures and internal control. It seems reasonable to assume that if a review indicates that procedures and controls relating to fixed assets are good, the auditor's examination can be limited to an evaluating test of such procedures and controls in an interim period and a general review of transactions for the year, with an investigation of unusual items. It does not seem necessary to fill the working papers with voluminous schedules detailing additions and retirements to be tested. Testing can be just as effective if it is made directly to the client's records, and working papers include only a write-up of work done and exceptions noted for follow-up.

If the client has a well defined policy of accounting for capital and expense items, and if this is tested by including charges to repairs and maintenance expense in the regular voucher examination, there does not seem to be much justification for additional vouching of this account. A comparison of monthly balances and an investigation of unusual fluctuations should disclose any material deviations from prescribed procedures.

LIABILITIES

Another procedure frequently included in the independent auditor's program calls for vouching, and occasionally some confirmation, of year-end accounts payable. Assuming that a satisfactory interim voucher test was made and that internal controls are good, it seems to me that with very rare exceptions no vouching of accounts payable should be done at year-end, and that there are few occasions which require confirmation of accounts payable. It is difficult to justify the detailed verification of year-end trade payables and at the same time to take the position that no detailed year-end verification is required of inventories and customer receivables if interim tests have proved satisfactory. By the same token it is logical to obtain satisfaction as to recorded payables at the balance sheet date through an interim review of procedures for recording liabilities and through a review of unusual fluctuations between months in the contra debit accounts. The year-end examination can then be confined to a search for liabilities which may not be recorded rather than verification of those which have been recorded.

I believe that some auditors may be guilty of too much work and too much scheduling in connection with the examination of the liability for payroll taxes withheld and accrued. It does not seem necessary to schedule the details of taxable wages, tax rates and quarterly payments for the entire year. A review of quarterly returns and payroll records and the examination of subsequent tax payments should generally suffice. There is also no reason, in most instances, why the payroll tax liability cannot be tested as of a quarter-end during an interim examination, and balances at that date compared with those at year-end.

INCOME, EXPENSES AND PROCEDURAL TESTING

In connection with vouching and sales tests by the independent auditor there are, I believe, two general techniques currently in use—the representative selection (or selected transaction) approach and the period test.

The period test has been described as the "two-pile" method, meaning that all vouchers, sales invoices, or other documents for a selected period are placed in a pile, examined one by one, and placed in a second pile. When the first pile is exhausted the test is over. This technique has the merit of simplicity and also a flexibility of manpower requirements in that it would presumably require a less imaginative approach. The selected transaction approach involves the selection of one or more samples of every typical transaction, both debit and credit, recorded during the year (or year to date of test). The selection should probably be made from the books of final account (that is, the general ledger or subsidiary ledgers) to insure complete coverage of all major types of transactions. Each transaction selected is reviewed from its inception to its completion as to authorization, documentation, clerical and supervisory review, accounting distribution, and general propriety. This approach will generally require assigning a more experienced man to the job who will know what to look for and how to evaluate what he finds, but it has the advantage of providing a broader coverage and, consequently, a better insight into the overall operation of the company. It does not involve the limitation of reviewing only those transactions falling within a selected period, or the non-productive time consumption inherent in examining a number of similar transactions. On balance, the selected transaction approach appears to offer more benefits than the period test. Regardless of the technique selected, scheduling the details of vouching, payroll and sales tests should be avoided wherever possible. A write-up of work done and exceptions noted should generally suffice.

While most of the audit emphasis with respect to income and expenses is placed on procedural testing, through the sales, voucher and payroll tests, audit programs frequently call for the analysis of specific income and expense accounts. In my opinion this is probably overdone in some cases. For example, I do not believe it should generally be necessary (except for the accumulation of data for tax returns, which should be done by the client whenever possible) to analyze contributions, officer salaries, professional services other than legal, or travel and entertainment expense. There may be some merit to obtaining (from the client whenever possible) analyses of legal fees (for the possible disclosure of unrecorded or contingent liabilities), miscellaneous expense (for possible misclassifications) and non-operating income and expense. In general, however, the investigation of unusual fluctuations from month to month in income and expense accounts is preferable to the analysis of specific accounts.

ADMINISTRATIVE PLANNING OF AN AUDIT

In addition to the consideration of audit procedures and techniques, it may be appropriate to discuss briefly the approach to auditing from the standpoint of administrative planning. Certainly many of the benefits of revising an audit program to give effect to changing procedures and techniques may be lost if the examination is poorly planned and poorly administered.

The question of who should perform the administrative functions outlined in the discussion which follows will depend on the size of the accounting firm and the size of the engagement. Some of the suggested administrative procedures will obviously be inapplicable in smaller engagements, but the size of the job should never serve as an excuse for poor administrative planning.

PRELIMINARY PLANNING

There are a number of areas to which the auditor should give his attention prior to the commencement of his field work. These would include such matters as: (a) logistics (manpower assignments, locations to be visited, letters of instruction to other offices of the firm, plans for physical inventory observation and accounts receivable confirmation, etc.); (b) a review of the prior year's questionnaire on internal control and a review of the audit program, with a view to revising and updating the program; (c) a review of the correspondence file for recent developments which might have a bearing on the audit; and (d) a review of work done by the client's personnel in prior years and preparation for similar work during the current examination.

Pre-audit contact with the client might include furnishing him with stationery and a list of schedules to be prepared, and arranging for the use of his personnel as assistants working directly on certain phases of the audit. In this latter connection consideration must be given to those phases of the audit in which it is feasible and/or desirable to use the client's personnel. Generally speaking, the requisites for such use are that the employee be independent of the activity he is auditing, that he have the ability to do a competent job, and that his work not result in the substitution of his judgment for that of the independent auditor. Work requiring such exercise of judgment, and therefore not suitable for assignment to personnel other than the auditor's own staff, would include vouching, payroll and sales tests, and the reading of minutes and contracts. Work which might be suitable for assignment to the client's personnel under the supervision of the independent auditor would include physical inventory tests, preparation of trial balances, cash counts, bank reconciliations, receivable confirmations, preparation of tax return and 10-K schedules and various balance sheet and expense account analyses.

Large engagements undertaken by multi-office accounting firms frequently involve work by more than one office. Since primary responsibility rests with the office initiating the work, it is suggested that a letter of specific instructions to the office performing the work be written, to accompany the audit program and working papers of the previous examination, covering such matters as: (a) the scope of the examination; (b) the suggested classification of men required; (c) a time budget; (d) a deadline for completion of the work; (e) the type of finished product required (i.e., working papers, letter report, rough draft of financial statements, letter on internal control, etc.); (f) a request that the working papers include a summary of audit findings, comments on internal control, suggestions for revision of the audit program, and a comparison of actual and budgeted time with an explanation of variances; and (g) comments by the initiating office resulting from a critical review of working papers from the previous audit, with a view to improving the current year's examination.

ON-THE-JOB ADMINISTRATION

There are, of course, a number of administrative responsibilities in connection with the conduct of a field examination. Most of these are routine and second nature to the competent auditor. However, I should like to offer for consideration a few suggestions (or reminders) which I believe can assist in improving the efficiency and effectiveness of the auditor's work.

Working papers are the backbone of the examination, and they should

stand the test of time. Meaningless schedules and miscellaneous notes and "to do" lists of no lasting value should be eliminated. The papers should be free from questions or comments which are unanswered or to which the answers and explanations are vague or unintelligible. Audit findings should be summarized and easily accessible.

Interim audit findings should be discussed with the client at the conclusion of preliminary work and followed up at the year-end. Possible year-end adjustments and matters pertaining to statement presentation (including such questions as comparative statements, penny elimination, and combining of captions) should be discussed prior to the year-end, if possible, to permit a considered decision by the client. Worthwhile suggestions are sometimes turned down solely as a result of poor timing. Also prior to the year-end it is desirable to work out with the client a year-end closing schedule or timetable for the accomplishment of various phases of the work by both parties.

CONCLUSIONS

An attempt has been made in the preceding pages to evaluate some of the procedures and techniques which are included in a number of audit programs today, and in certain cases to suggest alternate approaches. In considering these comments and suggestions, it is important, I believe, to bear in mind two things. First, not all of the comments and proposals will be applicable in every engagement. The size of the client and the degree and quality of his internal control will determine whether some of the suggested procedures are practicable. (Size alone, however, should not automatically operate as a deterrent to eliminating unnecessary audit procedures or to adopting more effective alternate procedures.) Second, the proposals which I have suggested should not be interpreted solely as an attempt to reduce audit work. Rather, they represent a program for increasing the effectiveness of the work within the framework of the generally accepted scope of an examination incident to the expression of an opinion on financial statements. True, I have proposed the elimination of certain "traditional" audit steps, but I have also suggested a shift in emphasis (more procedural testing, the use of a selected transaction approach rather than a period test, etc.) which will in all probability result in an increase in audit time in certain areas.

The discussion of specific audit procedures was prefaced by a consideration of the effect of internal control and of the auditor's responsibility for fraud detection on the scope of his examination. The position taken by the writer is that the volume and timing of the auditor's work are entirely dependent upon his review of his client's internal control, and that the limitation on the auditor's responsibility for the discovery of fraud will also have a direct bearing on the scope of his examination.

Consideration has also been given to certain administrative procedures, both pre-audit and on-the-job, and it has been suggested that close attention to audit administration and planning is equally as important as sound auditing procedures in the successful conduct of an engagement.

With the rapidly increasing cost of maintaining a competent audit staff it is incumbent upon every accounting firm and practitioner to operate at maximum efficiency. This requires a constant alertness to and ability to adjust to changing techniques. Auditing is not an exact science. Certainly auditing procedures should be neither static nor inflexible.

Interstate Business Taxation

By HARRY KATZ

Several recent court decisions reflect an expanding permissible scope of state taxes on interstate business. A partial brake on such expansion was exercised by recent Congressional legislation. The cumulative effect of these developments is analyzed by the author, as applied to direct net income taxes and apportionment of income, gross receipts taxes and use taxes.

To tax advisors ever hopeful of greater certainty in the law, recent developments in the field of state taxation of interstate business yielded small comfort. In an area where the Supreme Court has itself said that nice distinctions are to be expected, and what has gone before will not necessarily guide the future, further controversies have arisen.

It will perhaps aid in better understanding the latest happenings if certain basic concepts are first examined. The source of any discussion in this field is, of course, the Commerce Clause of the Federal Constitution. This provision merely declares that Congress shall have the power to regulate commerce among the states.[1] The clause, it will be noted, does not *in terms* prohibit the states from imposing taxes on interstate commerce.

However, certain state levies in their nature or their application may tend to impede the free flow of commerce among the states—which it was the aim of the Commerce Clause to promote—and thereby interfere with the Congressional power to regulate such commerce. It has devolved upon the Supreme Court to determine in what circumstances a state or local tax may be said to conflict with the federal power over interstate commerce. Although the Court has from time to time announced general principles to serve as guides in resolving this issue, the decisions of the Court still manifest a case-by-case approach to the task of accommodating competing state and federal interests. As a result there has grown up a body of decisions which say a great deal but are scarcely instructive and, to use the Court's own words, are a "tangled underbrush."

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THE NORTHWESTERN CEMENT CASE AND PUBLIC LAW 86-272

In the landmark *Northwestern Cement* decision handed down early in 1959,[2] the Court sought to clear away some of the underbrush. In that case

[1] U.S. Const., art. 1, sec. 8, cl. 3.

[2] *Northwestern States Portland Cement Co.* v. *Minnesota,* 358 U.S. 450 (1959).

it upheld a Minnesota net income tax imposed on the exclusively interstate operations, apportioned to Minnesota, of an Iowa corporation which maintained only a small sales office in the taxing state. All goods ordered by Minnesota customers were shipped to them F.O.B. Iowa plant.

Prior to this decision it had been commonly thought that the net income of a foreign corporation engaged in activities which were solely in furtherance of interstate commerce could not be constitutionally subjected to tax. In 1951 the Court had apparently so held in the *Spector* case.[3] In *Northwestern Cement,* however, a distinction was drawn between a tax imposed directly on net income which the Court declared does not interfere with the federal power over interstate commerce, and a tax such as was involved in *Spector,* imposed for the privilege of doing interstate business and measured by net income, which falls directly on interstate commerce. The Court reaffirmed that no state could levy a tax on the *privilege* of conducting an exclusively interstate business.

It may be noted here that neither the New York State Franchise Tax nor the New York City General Business Tax was affected by this decision, as both are deemed to be privilege taxes.[4]

The *Northwestern Cement* decision was also significant for the implication carried in its language that even if a foreign corporation does not maintain an office in the taxing state but solicits business there by means of traveling salesmen, it can be held liable for the state net income tax.

Since thirty states levy direct taxes on net income, with varying formulas for the apportionment of income, the possibility of multiple taxes on small business under the new rule aroused Congress to quick action. Acting under its power to regulate interstate commerce, it enacted a law to limit the power of the states to tax nonresident business concerns upon their net income from interstate operations.

Public Law 86-272, which took effect September 14, 1959, provides that no state may tax such income if the *sole* activity of a nonresident business concern in the taxing state consists of solicitation of orders for tangible personal property, either for its own account or for the account of its customers, and the orders are accepted outside the taxing state and are filled by shipment from a point outside the state.[5] Further, the concern may not be subjected to tax because it is represented in the taxing state by an independent agent who also acts for other principals even if the agent maintains an office in the state.

What, then, is the cumulative effect of the *Northwestern Cement* decision and the federal statute which followed it?

1. A nonresident business concern is subject to a net income tax upon its operations in a taxing state, even if those operations are exclusively in furtherance of interstate commerce, if the concern maintains an office in the state from which orders are solicited.[6]

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[3] *Spector Motor Service* v. *O'Connor,* 340 U.S. 602 (1951).

[4] New York State announced after the *Northwestern Cement* decision was rendered that it will not apply the franchise tax to out-of-state companies engaged exclusively in interstate operations. For a holding as to the nature of the New York City tax, see *Matter of United Piece Dye Works* v. *Joseph,* 282 App. Div. 60 (1st Dept. 1953), aff'd 307 N.Y. 780 (1954), cert. den. 348 U.S. 916 (1955).

[5] The statute does not limit the states in their power to tax net income from services. It does not, for example, afford protection to persons engaged in rendering transportation, processing, communication, advertising or other services across state lines.

[6] If a company maintains a plant or stock of goods in a taxing state, it is clearly taxable.

2. A nonresident concern is not subject to tax if it merely sends in salesmen or "missionary men" to solicit orders (which are subject to acceptance outside the state and are delivered from an out-of-state point), or if the concern is represented by a manufacturer's agent in the state.

Under Public Law 86-272, soliciting business merely by mail, or newspaper and magazine advertising, or radio and television promotion, would afford immunity from tax. However, once a company engages, in addition to solicitation, in such other operations as repairs, installations, handling complaints, etc., the protection of the statute would probably be lost, for the statute prohibits state taxation if the "only" business activity conducted in the state is solicitation.

The statute provides that the Senate Finance Committee and the House Judiciary Committee shall study all matters relating to state net income taxation of interstate commerce in order to recommend legislation to Congress establishing uniform standards for such taxation. These committees are required to report to Congress by July 1, 1962. In that sense, Public Law 86-272 may be regarded as a stopgap pending the establishment of a legislative program for state taxation of net income of interstate business.

APPORTIONMENT OF INCOME FROM INTERSTATE COMMERCE

In speaking of the creation of uniform standards for the taxation of interstate business, Congress was doubtless referring mainly to the promulgation of a uniform formula for the apportionment of income from interstate commerce.

The purpose of an apportionment formula is to break down total income so that only that part of the income is subjected to tax in any state which properly reflects the activities carried on in that state. Stated differently, apportionment seeks to prevent multiple taxation of the same income by the states in which a company conducts its activities. Such cumulative taxation is, of course, invalid.

This is not to suggest that precise mathematical accuracy is essential to an apportionment formula. The courts have held that a rough approximation will suffice.[7] Although the apportionment formula must be fair and reasonable, the burden of proving that it is not so, either on its face or in its application to a taxpayer, is cast upon the taxpayer.[8]

Most states have adopted a three-factor formula which employs the factors of property, wages, and receipts.[9] In each of these factors the value in the taxing state is proportioned to total value, the three fractions are totalled, then divided by three to arrive at the average which is applied to net income. The result is the portion of the taxpayer's net income subject to tax. Certain types of income such as rents, royalties, dividends and interest, are separately allocated according to specific rules and do not enter into the formula as part of the receipts factor.

From this brief analysis it is clear that tax minimization requires that the numerator in any or all factors be reduced to the extent possible. This involves important business considerations. For example, reducing the property numerator may require the removal of plant or inventory from the taxing state. Lowering the wage

[7] *Illinois Cent. R. Co.* v. *Minnesota*, 309 U.S. 157 (1940).

[8] *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission*, 266 U.S. 271 (1924).

[9] Some states utilize two factors; others, a single factor.

numerator would in all likelihood require relocation of an office. Even such removal would not always accomplish its purpose, however, for some states include in the payroll numerator time spent in the taxing state by salesmen. In order to reduce the receipts numerator it is particularly important to study the formula involved, for the states differ substantially in allocating receipts. Some allocate receipts to the state of delivery, others to the place of negotiation, still others to place of approval of the order, and so on. Lowering the receipts numerator will therefore depend in each case upon the provisions of the particular formula.

GROSS RECEIPTS TAXES

In *Matter of United Piece Dye Works* v. *Gerosa,*[10] the City of New York sought to impose its General Business Tax upon a company engaged in the business of dyeing textiles belonging to its customers. The company maintained a substantial office in New York City at which advertising and promotional activities were carried on. However, orders were subject to acceptance at the company's plant in New Jersey where the dyeing operations were conducted, and the finished goods were shipped from the plant to customers in New York. The Court held that the activities carried on through the New York office were all incidental to the company's interstate business, and the company could not be subjected to a tax on gross receipts for the privilege of doing an exclusively interstate business.

A recent case involving the same tax was distinguished from *United Piece Dye Works* and the tax was upheld. In *Berkshire Fine Spinning Associates* v. *City of New York,*[11] a foreign corporation manufactured and sold fabrics which were shipped from its out-of-state plants to customers in New York City. The company's offices in the City accepted orders, checked credit, maintained certain records and gave production instructions to the company's out-of-state mills. Bills were rendered by the New York office and payments were received there. The Court declared that the company's activities in the City represented local operations separate from interstate commerce, and sufficient to justify the imposition of an apportioned gross receipts tax. In short, since the taxpayer was not engaged solely in interstate commerce, it could be taxed for the privilege of doing business.

From this brief analysis, the principle emerges that if a nonresident business concern engages in the City of New York solely in soliciting orders for sales or services in interstate commerce, it is not subject to the New York City General Business Tax for the exercise of this privilege; on the other hand, if it engages in other activities locally in addition to solicitation and promotion, such as making sales contracts, etc., it is subject to tax.

USE TAXES

With a marked increase in interstate selling in recent years and the development of new methods of selling, the states which impose use taxes have devoted greater effort to requiring out-of-state sellers to collect the tax on sales made to residents. The use tax, as is now familiar, has been adopted as a complement to the sales tax in order to prevent tax-free purchases by residents from out-of-state

[10] 282 App. Div. 60 (1st Dept. 1953), aff'd 307 N.Y. 780 (1954), cert. den. 348 U.S. 916 (1955).

[11] 5 N.Y. 2d 347 (1959), app. dis. 361 U.S. 3 (1959).

sellers and to protect local merchants from the ensuing competitive disadvantage.

Unquestionably, a state may require an out-of-state retailer who maintains a local office to charge and collect the tax, and this is so even where the local office has had nothing to do with a particular sale.[12] Can a state compel a nonresident seller to collect tax where he does not maintain a local office there?

In the *General Trading* case[13] the Supreme Court held that a nonresident company could be required to charge and collect use tax where it regularly and systematically sent its salesmen into the taxing state to solicit business, the orders being subject to acceptance in the home state and the goods being shipped from that point. And this year, in *Scripto* v. *Carson*,[14] it was ruled that a nonresident seller is required to collect tax even where orders are solicited by independent sales representatives who also act for other principals.

It may be observed that the City of New York for many years has adhered to the position now confirmed by the *Scripto* decision, that out-of-City vendors are required to charge and collect the New York City compensating use tax upon retail sales made to New York City customers where such sales are effected by means of orders taken by the company's own employees or by independent contractors.[15]

A number of states have asserted the right to require nonresident sellers to collect use tax if sales are effected merely by catalog, or radio or newspaper advertising. Even though sellers are undoubtedly exploiting a local market through this form of solicitation, there is a very substantial question as to whether this type of activity constitutes sufficient "nexus" so as to afford the requisite jurisdiction over the seller. In *Miller Bros.* v. *Maryland*,[16] a Delaware seller who made deliveries to Maryland customers and also reached them by direct mail and "spill-over" newspaper and radio advertising, was held not liable for collection of the Maryland use tax.[17]

CONCLUSION

The states and localities, to satisfy the multiplying demand for increased public services and benefits, have been casting about for new and additional sources of revenue. In doing so, they have directed their attention not only to wholly local business but also to activities in some way related to interstate operations, for all of these derive some advantage from local services and exploitation of the local market.

The recent decisions discussed in this article, which reflect an expanding permissible scope of state taxes on interstate business, render it manifest

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12 *Nelson* v. *Sears, Roebuck & Co.*, 312 U.S. 359 (1941).

13 322 U.S. 335 (1944).

14 362 U.S. 207 (1960).

15 Sales Tax Regulations, Art. 4.

16 347 U.S. 340 (1944).

17 Thirty-four states, the District of Columbia, and many localities impose a use tax. Following the decision in *Scripto*, bills were introduced in both houses of Congress to amend Public Law 86-272 so as to prohibit the states from requiring nonresident retailers to collect use taxes if the retailers' only activity in the taxing state consists of solicitation by salesmen or independent representatives. In effect, these bills would undo the holdings of both the *General Trading* and *Scripto* cases. The House bill was referred to the Judiciary Committee and the Senate bill to the Finance Committee. The Senate committee eliminated the basic provisions described above, leaving only a provision for study of sales and use taxes imposed on interstate transactions, and reported the bill as thus amended. However, no definitive action was taken on these bills at the last session of Congress.

that a growing attention to this field is required. This is also evident from the fact that state and local tax collections have been increasing in recent years to a point where they are significant.

We are well past the day when state and local tax liability meant liability for taxes of the state and the locality in which a business was principally based. Today a business may remain in the place it considers home, and nevertheless expose itself to the tax levies of other states and localities. Once this essential fact is recognized, adequate business and financial planning must be given due consideration.

A Library of Experience

Fishing with a bent pin is said to be a relaxing pastime, but the man who enjoys landing a big one insists on using a barbed hook. Many members of our own profession are content to sit on the bank and take what comes their way, but those who want their clients to stay with them know they must strengthen their professional status. The business man of today is no longer satisfied with an annual audit. He wants the additional benefit of current changes and new ideas affecting him. If his accountant cannot keep abreast of the times he will satisfy his appetite for new techniques elsewhere. To keep ahead in his game, the angler goes to the sporting goods store to look over the latest lures and swap stories with fellow fishermen. Their love for fishing is the tie that binds this group, but sportsmen know such association is to their mutual advantage. The CPA has a library of experience and current ideas available to him through membership in his local society. No amount of reading or research is more advantageous to an accountant than his association with those engaged in the same profession.

Whether in his hobby or in his business, the extent of a man's interest is indicated by his desire for improvement. Maintaining the status quo reflects not only on the man, but on the profession he practices. The CPA has a duty to his client to render the best service of which he is capable, but his responsibility does not end there. From the day he receives his certificate until the time of his retirement, he represents the entire accounting profession. He can hardly do a creditable job if he is not affiliated with his professional society and has no contact with his fellow practitioners.

John C. Ethridge, "Professional Help Wanted,"
The Georgia CPA, Summer 1960

The Cost-Reduction Program

By M. B. T. DAVIES, CPA

The success of a cost-reduction program will depend largely on the attitude of top management. A clearly defined program is needed, targets should be attainable, and efforts made to see that they are achieved. This article pinpoints the factors which may cause excessive costs, outlines the role of management in developing and executing the program, and presents the ground rules to be observed in searching for opportunities to reduce costs.

Prosperity often breeds inefficiency. Under the cover of adequate profits, a business may accumulate—and overlook—areas of waste, inefficiency and unnecessary expense. The power to question these areas progressively wanes, and they are eventually accepted as normal operating conditions. The standards which they generate are built into the business budget, and continuing prosperity detracts from the incentive to take corrective action.

Consequently, a business recession arrives during a period of atrophy, when it is difficult to isolate and destroy these conditions. All too often, the realized need for reducing costs leads to panic action, such as: across-the-board reductions in manpower and budgets; postponement of important and necessary projects; excessive concentration on reducing insignificant cost items; and curtailment of necessary services. Seemingly, the ideal time for pursuing an active program of cost-reduction is during a period of prosperity. However, the incentive is then less pressing, and methods, practices and policies leading to excessive costs may have become so deeply ingrained that the task of reducing costs is very difficult.

A cost-reduction program requires systematic planning and execution. In particular, it calls for an understanding of the causes of excessive costs, active leadership and support by the top management, and adoption and pursuit of effective measures.

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CAUSES OF EXCESSIVE COSTS

Policies. Management policies may create unnecessary expense. These policies may be inherently unsound, they may have been erroneously interpreted, or they may have become outmoded with the passage of time. For example, assume that management sets a formula for deciding the annual limit of capital expenditures. If excessive, it may permit wasteful expenditures to be incurred; if inadequate, operating costs may be unduly high because of failure to modernize, replace or purchase equipment.

Lack of management effort. A constant drive is needed to seek out and eliminate unnecessary or excessive expense. Management failure—at any level—is a common cause for perpetuating inefficiency in this respect. Thus, if standard unit costs are used for appraising operating performance, they may not reflect recent method improvements. Operating inefficiencies may be hidden under a cloak of false standards.

Inadequate planning. Each change in operations and business conditions calls for plans to be re-evaluated. Changes in plans are sometimes overlooked; at other times they develop through a subconscious adherence to precedent. Unnecessary expense is a common result. A business, for example, may introduce a second-line grade of product to supplement its original line. It paints, finishes and packages its new line acording to existing specifications. However, less superior—and less costly—standards might be appropriate for its second-line products.

Empire-building. Officials sometimes add to their subordinate work force and functions in an effort to increase their personal stature. This tendency may escape detection when business conditions are satisfactory and activity is on the increase. Consider, as an illustration, a home office industrial relations division which has staff counterparts at each plant. Their work is similar, it overlaps, and active communications take place between the home office and plant staffs. Economy could be gained by centralizing the staff.

Lack of imagination. Consistent exposure to a specific condition may cause one to accept it and fail to observe opportunities for improvement. The imagination becomes dulled, and potential savings are not realized. For example, the manufacturing process requires a flow of semifinished products from one type of machine to another. Machines are physically grouped by type for ease in supervision. By a change in plant layout and supervisory philosophy, it would be possible to group machines according to production flow rather than type. This would eliminate excessive products movement within the plant, and permit better control of quantities of semifinished products.

Outmoded techniques and equipment. Busy attention to its daily problems and tasks often prevents management from devoting sufficient time to the study of new developments and trends. Facilities for improving methods, techniques and equipment are constantly becoming available, yet their potentialities may not be fully explored. Consider the case of a large payroll department which compiles data from time cards and job cards, calculates payrolls, distributes payroll expense and prepares pay checks—all by hand. Its work may be performed more accurately, more speedily and more economically through the adoption of punched card techniques.

Corporate fictions. Many businesses are engaged in a multitude of operations, particularly when there has been a conscious move to diversify. Some operations are performed by corporations acquired through merger; others by separately created subsidiaries. A multiplicity of organizations and methods tends to be created and may be overlooked because separate corporate entities are involved. In a group of associated corporations, for example, there may be a separate purchasing department in each corporation. By combining these departments it may be possible to reduce administrative expenses, gain important advantages through combining purchasing power

and ordering in larger quantities, and stimulate intercorporate transactions.

Absence of incentives to save. The business activity responsible for the production function is generally constantly aware of the need for controlling costs. Overhead departments, on the other hand, tend to emphasize the value of the services they provide and become less conscious of the need for controlling costs. After engaging in his "annual battle of the budget," indeed, the manager of an overhead department is frequently satisfied merely to operate within his budget; exceptional savings might prejudice his budget in the succeeding year. This may be illustrated by reference to a company which has a number of regional offices which process customer orders. By developing and publishing unit processing costs, it may instill a spirit of competition among the regional offices, provide an inducement to cut these costs, and establish keener standards for future budgets.

Lack of supervisory perspective. The pressure of daily routine and the inertia caused by adherence to accepted practice tend to reduce a manager's ability to review his operation objectively. Chances to produce fundamental improvements are consequently passed by. His superior is often similarly placed, and unable to compensate for this loss of perspective. As an example, assume that excessive scrap and rework expense is caused by the adoption of unreasonable inspection standards. The situation may be disclosed by an inspection made by a home office team that provides an entirely fresh and independent viewpoint.

Inadequate information. Effective information is the springboard for productive action. Sometimes that information is not developed; at other times, even though available, it is not presented to the people who can use it to stimulate action. An illustration of this would be a multiple-plant company which ships products on a nationwide basis at uniform prices, F.O.B. destination, and absorbs transportation expense. Each plant develops statistics on the effective selling prices for each destination after providing for freight costs. The company traffic manager may be able to arrange for switches of delivery points among plants and thus reduce freight costs.

Luxuries. Certain expenses add to the comfort of working conditions and improve the morale of employees, customers and others. While not wholly necessary, they have a "public relations value" and may be justifiable in favorable times. However, they call for re-evaluation in a period of adverse business conditions. To illustrate: Regional salesmen's conferences are held annually at resort country clubs. The programs are spread over a period adequate to provide for relaxation and entertainment. As a result of reduced sales, it may be desirable to hold the meetings in company premises or nearby hotels, condense the programs, and let the salesmen know that country club meetings will be resumed when sales improve.

Unprofitable time. Employees' time is generally fully occupied in a period of intense activity, and the work force grows to absorb the excess of work-to-be-done over available working capacity. With a downturn in business, a lag generally occurs before the work force is reduced. The extent of unprofitable time, particularly in overhead activities, is not readily discernible because work tends to be done more slowly and otherwise idle time is camouflaged. Assume, for example, that invoices are prepared at decentralized sales offices. By keeping sta-

tistics of the relationship of invoice volume to paid man-hours, the company should be able to compare present with past productivity and to appraise the performance of one office against another. As minutes-per-invoice become excessive the company should order staff reductions.

Slack buying practices. Under the pressure of active business conditions, a purchasing department may be compelled to adopt short-cuts, to buy in inappropriate quantities, to devote inadequate care in securing bids, and to spend insufficient energy in exploring markets and consulting with suppliers. Thus, a company may buy parts for its manufacturing operations according to standards defined by its engineers. The purchasing agent may invite its suppliers to visit the plant, watch its operations and meet the plant management. He may explain the urgent need for reducing costs and call for the suppliers to make a contribution. By careful examination of specifications and discussion of alternatives, the suppliers may be able to produce a less costly product by fabricating it to less exacting or less expensive standards.

Overstocking. The hazards of excessive or ill-balanced inventories are less apparent when sales are rising, when an atmosphere of optimism prevails, and when the principal concern is to be prepared to meet every sales opportunity. An unfavorable business trend often develops with dramatic suddenness. Inventories reach disproportionate levels; slow-moving stocks, obsolescence and spoilage become matters of greater concern; and a drive is instituted to reduce inventory levels. Changes in inventory policy should then be explored. Consider, illustratively, the case in which inventories are carried in ample quantities at decentralized warehouses, supplied from a centrally located plant. It may be desirable to reduce decentralized inventory levels and make greater use of central storage facilities. The total inventory investment may then be reduced and production schedules geared to a level where greater protection is afforded against excessive inventories in the face of a falling market.

Inefficient routines. The methods of performing repetitive tasks, though individually insignificant, may have an important collective influence on costs. When the methods are first installed, it may not be possible to visualize the ultimate volume, and, as the activity expands, the basic methods may be insufficiently questioned. Potential savings may be gained through work simplification, elimination of routines, combination of tasks, or discovery of duplicated effort. However, the necessity for the over-all activity should be studied before attention is given to the methods involved. A good illustration would be the procedure whereby a shipping order, bill of lading and invoice are each prepared for every outgoing shipment. When items are not immediately available, a back order requisition is also initiated. It may be possible to originate a single all-purpose document to meet all these needs, using a reproducible "master" for recording the essential data. This should reduce clerical time and eliminate transcription errors.

Watered budgets. The budget is sometimes an illusory standard for controlling expense. Budget requests frequently include margins for "contingencies" which are not entirely eliminated in the budget reviews. In itself, the budget provides an adequate measurement device only when linked in with a factor based on volume. Consider this example: A drafting department has successfully requested an increased budget. However, its costs may be evaluated when expressed in

terms of cost per authorized drawing produced. If this factor is introduced, department expense may be subjected to a dual type of budgetary control, one expressed in terms of absolute dollars and the other based on productivity.

Here, then, are some of the major causes which should be explored in an endeavor to reduce costs. But the process of seeking them out will generally be burdensome and may not develop at the pace necessary to produce substantial savings rapidly. A coordinated and systematic approach therefore becomes a necessity.

MANAGEMENT'S ROLE IN STIMULATING ACTION

The management should control a cost-reduction program through exercising broad supervision rather than by becoming involved in its routine aspects. It should define targets rather than specify detailed methods. It should review progress rather than penetrate deeply into individual problems.

In developing and executing a program of this type, it will generally have a fourfold task:

1. It should specify the objectives to be achieved.
2. It should define the reasons for the program and formulate the general course of action to be pursued.
3. It should assign responsibilities for getting the work done.
4. It should review achievements, exercise follow-up action, and recognize individual and collective performance.

SPECIFYING THE OBJECTIVES

The savings targets should be determined first. A profit-and-loss projection should be made, based on expected business conditions, with the underlying assumptions slanted pessimistically rather than optimistically. The projected profit or loss thus developed should be compared with the desired profit; the difference will disclose the extent of the savings required to achieve a satisfactory profit. Potential savings should then be estimated for each significant organizational unit. The aggregate of these potential savings will differ from the tentative target previously calculated, but the two amounts will provide the extremes of a range within which a target should be established.

After additional refinement, savings targets should be produced in separate amounts for each significant organizational unit, the total representing the aggregate business target. Organizational objectives need not be substantiated by detailed estimates, although reasons should be provided to justify their general magnitude. The managers should be shown the complete picture, including their own targets in relation to the total business objective and that objective as an influence on the profit-and-loss projection.

ANNOUNCING THE POLICY

The program should be announced affirmatively and convincingly. It should preferably be presented by the chief executive officer orally before his key officials. They should be made to understand that the cost reductions are regarded as essential and that their own departmental contribution is imperative to achieve the total objective. Where operations are dispersed, visits should be made to outlying officials, or other suitable means such as telephone or closed-circuit television should be used. The presentation should be as simple and inexpensive as possible, because of the adverse effect of too elaborate an exposition.

Each organizational chief should

understand that he may call on all available resources of the organization in attaining his target. He should be encouraged to use bold and unconventional measures, subject only to policy checks at the appropriate level. He should also recognize that a shifting of costs organizationally will be acceptable only if its total effect will result in net savings.

Time limits should be set for the production of results. These limits will naturally tend to vary directly with the magnitude of the savings desired.

ASSIGNING THE RESPONSIBILITIES

A twofold approach is generally desirable for assigning responsibilities for reducing costs. Each organizational chief should, in the first place, be allotted a savings target. It should be his soie responsibility to see that the target is achieved. Then, in addition, staff support should be provided so that the organizational chiefs can receive maximum assistance. Because of the certainty of heavy demands on staff services, the staff organization will need judicious handling.

Organizational savings targets should apply both to line and staff functions. However, where costs are dependent on volume, the method of expressing savings targets will necessarily be different from those concerning functions whose costs are relatively constant.

Organizational chiefs should be encouraged to delegate authority and gain maximum support from their subordinates, and interdepartmental cooperation should be fostered in attacking problems of common interest.

A manager may miss opportunities to produce savings within his own department because he operates within a framework of policies and philosophies from which he finds it difficult to emerge and adopt a detached viewpoint and perspective. Because of this, the supporting staff organization may profitably be used to ramrod the over-all program.

The staff organization should be small, compact and hard-hitting. Its head should be a man of stature who has the confidence of the chief executive officer and his top executives. While the program is in effect, he should report directly to the chief executive officer; and, in a program of any substantial size, he should be relieved of all other duties and devote his full energies to it. His reponsibilities should be clearly defined and made known to key people in the organization. These responsibilities should include such tasks as the following:

1. Act as the chief executive officer's principal representative in coordinating the program.
2. Assist in providing for changes of policies necessary to produce savings.
3. Consult with and, where necessary, guide departments in achieving results.
4. Assist departments in providing technical and professional help beyond their available facilities, whether from central staff facilities, elsewhere within the organization, or the engagement of outside specialists.
5. Coordinate interdepartmental relations and mediate, as necessary, in any disputes.
6. Receive, review and publish progress reports.

In a business of sufficient size, it may be desirable to provide a group of people with varied backgrounds and specialties to give full-time assistance to the coordinator. Line, as well as staff, people should be considered in this connection, and the employment of outside specialists should not be overlooked. The group should be given

facilities to require priority assistance from specialized departments, such as industrial engineering, product design, operations research, purchasing, traffic, systems and procedures, accounting, engineering, and research. The maximum impact of available talent should be brought to bear in attaining the targets.

MAINTAINING IMPETUS OF THE PROGRAM

Results gained through the program should be recorded and conveyed to all organizational chiefs. This will not only preserve good communications, but will also engender competitive spirit.

When individual tasks are successfully completed, they should be reported to the coordinating unit. The budgets of the departments concerned should be reduced to the extent of the estimated savings, and performance should be watched to be sure that savings materialize.

The coordinating unit should publicize steps taken to produce savings so that other departments can capitalize on these ideas and apply them to meet their individual needs. One-time savings should also be reported. Even though they may not produce permanent or continuing benefits, they should nonetheless be recognized as a contribution.

Periodic reports issued by the coordinator should display the percentage progress made by each department toward its target. The coordinator or his staff should visit the department managements constantly, particularly those whose progress is unsatisfactory. He should make sure that interest in the program is being maintained; he should discuss projects on hand and under consideration; he should assist in pooling company-wide experience and skills; and he should see that adequate follow-up is exercised in installing approved projects.

The management should recognize individual and collective achievements in reducing costs. While monetary reward may sometimes be suitable, the effects of a personal letter from, or an interview with, the chief executive officer should also be considered. An interesting advantage to be gained from a program of this nature is the disclosure of hitherto undiscovered talent; and the management should be prompt to recognize it.

Finally, a basic organizational concept should be followed. With responsibilities lying in the hands of organizational chiefs and a program coordinator, the top management should allow them a broad scope of action. Good communications between them and the top management should be preserved, but the latter should endeavor to remain free from involvement in routine features of the program.

These four broad courses of action should be pursued by the management in initiating and conducting a program for reducing costs. It may now be appropriate to examine some guides to be followed for producing maximum tangible results in a minimum of time.

INSTALLING MEASURES TO REDUCE COSTS

Certain ground rules may profitably be observed in searching for opportunities to reduce costs. All who are actively concerned in the program should understand them.

GET RELIABLE INFORMATION

The availability of accurate and meaningful information is a fundamental need. Some may be available through the customary record-keeping; on the other hand, much may need

to be accumulated through one-time studies.

Effort should be devoted first to those areas where the savings potentialities are the greatest. It may require comprehensive analysis of operating statistics to show exactly where these areas lie. Operating data, to the fullest practicable extent, should be presented according to organizational segments; the economics of each organizational unit can then be studied separately.

External statistics are useful for comparisons. Inventory turnover rates in comparable industries, costs of producing purchase orders, costs per automobile mile, etc., may provide valuable yardsticks in reviewing the efficiency of internal operations. However, the fundamental risks in using this type of statistical information should be recognized.

SEEK OUT SACRED COWS

Almost every business has its sacred cows—operations, people, policies or groups whose usefulness is considered to be above question. A concentrated effort should be made to identify them, to plumb the reasons for their existence, and to explore the possibility of change.

Pet projects of individual executives are a common source of origin of these sacred cows. The originator should be prepared to accept questioning in an open-minded manner; and the questioning itself should be diplomatic. Changes may involve breaks with long-established precedent or tradition, and those changes may be hard to accept, even though they entail savings.

SEGREGATE DIRECT AND INDIRECT COST ACTIVITIES

The approach to direct cost savings will differ materially from the approach to gain reduction of indirect costs. A clear distinction should be observed, and direct costs should be interpreted in their narrowest sense—in terms of labor and materials that form the cost content of the product. "Direct overheads," such as foremen's compensation, supplies, maintenance, power and depreciation, should be regarded as an indirect expense.

Direct costs require examination in terms of the physical content of the manufactured product, the quality and content of the component materials, and the labor involved in fabrication. Indirect costs, on the other hand, call for a consideration of methods and other forms of control. Is it necessary, for example, to employ so many foremen? Can power costs be reduced by modifying the boiler system? Are monthly statements to all customers necessary when ten-day credit is standard? Can record-keeping needs be reduced by simplifying the basis of compensation?

EXAMINE THE SALES PICTURE

In exploring the opportunities for reducing costs, attention should be paid to sales features. An expansion of sales would spread the overhead load more finely. Are all opportunities being seized here—for additional product lines, for different grades, styles or colors, for hitherto underdeveloped markets, for better methods of distribution?

The cost of the product in relation to its market should also be considered. Where, for example, packaging and wrapping are significant costs, is there a potential market for a lower-priced unpacked or unwrapped product? Conversely, could a new luxury market be developed with a different product finish, different style or added features?

Then, too, the cost of selling should be examined. Many opportunities exist here. Greater concentration or dis-

persal of sales centers, sales compensation more closely tied to sales performance, changes in credit practices, changes in sales organization—all provide examples of matters that might warrant review.

START AT THE TOP AND WORK DOWNWARDS

Radical and dramatic steps are sometimes needed to cut costs. The more fundamental the action, the greater is the likelihood that it will be outside the framework of thinking on which the search is based. As a consequence, before examining possibilities within any function or activity, the reason for its very existence should first be questioned.

An advertising department, for example, may be unjustified if the advertising agency carries the load of the work. A container plant may be uneconomic if containers can be purchased advantageously from other sources. A research department may not be paying its way. A shipping department may be unnecessary if the warehouse can ship directly and avoid dual handling. Each activity, both "operational" and "overhead" should be scrutinized critically to see whether it can be eliminated.

Where elimination is not desirable, the inside working of the activity should be questioned. For example, is the department overmanned? Is each operation entirely necessary? Are work methods economical? Is there superfluous paperwork? Is work being duplicated? Are all expenses thoroughly justified? Is the cost of supervision too heavy? The manager of the individual department cannot always answer these questions in an unbiased manner. For this reason, the coordinating unit previously discussed should devote some of its time to a review of each departmental activity.

INQUIRE INTO THE COST OF INFORMATION

Whenever information is required, it entails effort—and therefore cost. New records—and additional paperwork—may have to be created, or existing records reprocessed. When information is required more rapidly, the costs tend to mount with it. More paper, more people, more machines, more storage facilities, and, as a result, more money are needed to fulfill these informational needs.

Before examining the cost of producing information, therefore, the need for the information itself should be questioned. This should be extended to cover deadlines, reporting frequencies, the degree of accuracy required, and the form of presentation. A ruthless reduction of the reporting system can produce surprising economies in overhead expense.

While the mechanized processing of information often lowers costs, there are times when it increases them. These mechanical methods should be critically examined and their cost should be compared with that of alternative manual methods.

DEVOTE EMPHASIS TO PROFITABLE ACTIVITIES

Lucrative discoveries may sometimes be made in connection with activities acknowledged to be unusually profitable or efficient, or where costs are consistently lower than budgeted. The reputations earned by these activities may have created a type of umbrella that has shielded them from close investigation. On the other hand, activities of an average, borderline or uneconomic nature are generally studied more frequently and more closely. As a result, opportunities for improvement sometimes lie in areas where they are least expected.

Those functions of a business which

produce exceptional profits, or which compare favorably with competitive enterprise, or which have grown considerably, or which consistently perform better than budgeted—all should be subjected to close review.

EXPLORE POTENTIALITIES THROUGH EXPERIMENTATION

Productive ideas are sometimes discarded because of the risk that attaches to them. To protect against this contingency, limited experimentation should be applied. Of course, reasonable steps should first be taken to reduce the risk factor to a minimum.

Experimentation offers particular advantages where:

1. The sales operation is decentralized.
2. There is a wide range of products.
3. There are several plant operations.
4. Individual segments of the business may safely be subjected to test without disturbing other segments.
5. The potential savings are so great that inherent risks are worth accepting.

Experimentation is worth attempting on a limited basis even when a full-scale change is approved. This better enables initial difficulties to be overcome before they assume company-wide proportions. Costly mistakes, too, can be limited if a testing period precedes full-scale adoption. When sample operations are tested, it is desirable, where possible, to apply the tests in more than one location so that initial results can better be evaluated. It is desirable, too, to conduct the experiments with the cooperation of people who are anxious to make them a success. This avoids resistance at the outset and provides standards for later achievement.

INVESTIGATE ONE-TIME ACTION OPPORTUNITIES

There may be opportunities for one-time profits or for the elimination of continuing losses through taking one-time losses. These opportunities are not always readily determinable from a review of operations or operating statistics. Examples are: reduction of slow-moving or obsolete inventories; disposal of fixed assets or investments; and refinancing of long-term debt. The long-range effects of these actions will need study, as will the tax aspects.

In assessing the desirability of discontinuing product lines or subsidiary activities (whether or not corporately distinct), it should first be ascertained that the operation is truly unprofitable and is not merely so from a bookkeeping viewpoint because of the method of apportioning overhead expense.

RE-EVALUATE TOP-LEVEL POLICIES

The ramifications of management policies on operating results are fundamental. Nevertheless, they are sometimes accepted through tradition or because of an emotional distaste for questioning them. There are those that originated through conditions that no longer exist, or because of personal idiosyncracies, or to counter competitive conditions that have since changed. A change in policy can often produce a much greater effect on profits than can a change in procedures.

Policies may be in the form of unwritten laws and, even when in written form, may not be entirely comprehensive. Their very existence may not be apparent until it is realized that they constitute a barrier against a proposed course of action. And this realization may not even occur, because conflict with existing philosophies precludes consideration of that action.

The fresh and independent viewpoint needed to re-evaluate company

policies may not exist among the staff responsible for heading the cost-reduction program. For this reason, the engagement of outside consultants may produce a more extensive viewpoint and reveal opportunities that would be overlooked by company men.

SUMMARY

The development and installation of measures to reduce costs is never a simple or painless task. Personal preserves may be trespassed; human feelings may be excited and disturbed; information may be inadequate, or opinions distorted; above all, job security may be endangered.

The success of a cost-reduction program will depend largely on the attitude of top management. A clearly defined program is needed; targets should be attainable, and efforts made to see that they are achieved. A firm attitude is needed, and progress should be followed with exacting care. Where progress is slow, pressure should be exerted, and ruthless action should be taken when the occasion demands.

The greater the need for cost-reduction, the more unpleasant the task becomes. But, once the program is started, it should be pursued with an irresistible drive until its objectives have been accomplished.

Managerial Services

In my conversations with accountants and officers of their clients I have been impressed with the number of situations in which the records have been inadequate, nonexistent for some periods, not up to date, and, particularly with respect to inventories, provide no book control over the assets of the companies. In these situations improvement in accounting control is important to investors as well as to management. The need for managerial services in these situations is obvious. The adoption of procedures which would result in better and more timely reporting to management might well be considered a prerequisite to an invitation to the public to entrust its funds to the venture. The need for such services is not limited to unregulated companies. Timely reports for management purposes are just as necessary in regulated companies and may be obtained while at the same time the needs of the regulatory agency are met.

Andrew Barr, "Accounting—Changing Patterns: The Impact of Regulatory Agencies," The Illinois CPA, Spring 1960

New York State Tax Forum

Conducted by PETER ELDER, CPA

REAL ESTATE CORPORATION: ADDITIONAL ASSESSMENT ON DISSOLUTION

Section 182 of the New York Tax Law provides, in part, that any corporation taxable under such section shall at the time of liquidation, or prior to dissolution, pay an additional tax based upon the sum of any dividends distributed and not heretofore used as a basis of any additional franchise tax as herein provided, and upon the sum of the corporation's actual net worth in excess of its actual paid-in capital, at the rate of two percent. Therefore, if the assets of a real estate corporation have appreciated in value at the time of dissolution, so that there is an excess of net worth over the actual amount of paid-in capital, an additional tax of two percent will be assessed on such excess.

An area of controversy which can arise upon dissolution of a real estate corporation whose assets have appreciated in value is the determination of the value of the assets. Suppose a real estate corporation sells its interest in realty for $6,000,000, and that it can show that shortly after the sale a valuation of $5,300,000 was reached in a tax certiorari proceeding in the Supreme Court of the State of New York. Must the State Tax Commission accept the lower valuation for the purposes of computing the amount upon which the additional tax is assessed under Section 182 of the Tax Law? This basically was the question which the court was asked to pass upon in a recent case. (*In the Matter of the Application of Broadur Realty Corporation* v. *State Tax Commission,* Supreme Court, Appellate Division, Third Judicial Department, March 18, 1960.)

In addition to the fact situation presented above, the case indicated that the petitioner owned an undivided one-half interest in the realty in question and that two individuals owned the remaining one-half interest. The entire fee was sold for $6,000,000 with the purchaser assuming an existing mortgage of $4,012,444.92, new second and third mortgages of $369,000 and $184,500, respectively, and a cash payment of the balance of $1,434,055.08. The individual owners accepted the second and third mortgages with the cash being apportioned accordingly as between the vendors.

The petitioner alleged that notwithstanding the sales price of $6,000,000, the Tax Commission was required to use the value determined in tax certiorari proceedings for the purpose of assessing the additional two percent under Section 182 of the Tax Law. Not so said the court. While the Commission may consider such valuation, it was not obligated to adopt it. The petitioner also alleged that the $6,000,000 sales price represented more than

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the true value of the real estate because that sum included some amount for the purchase terms used to induce the acceptance of the second and third mortgages by the two individuals. According to the case, however, no proof of this assertion and no evidence was offered to show that the price paid exceeded the market value obtainable on a cash sale.

In its decision the court stated: "It is not possible for us, upon this record, to hold either that the method of valuation employed by the administrative agency was arbitrary or unreasonable or that the result at which it arrived was unsupported by substantial evidence. On the contrary, the Commission was amply warranted in finding that the transaction was at arms' length and that under the circumstances it constituted the soundest and most persuasive evidence of value."

LOSS OF CLASSIFICATION AS REAL ESTATE CORPORATION

Section 182 of the Tax Law clearly provides that a corporation classified as a real estate corporation may hold or acquire the entire capital stock of one or more corporations taxable under such section and continue to retain its classification as a real estate corporation. Thus, a corporation so classified may acquire a wholly owned subsidiary, and if the subsidiary corporation is taxed under Section 182, the parent corporation will continue to be so taxed.

Suppose a real estate corporation acquires a corporation, also taxed under Section 182 of the Tax Law, which had obtained a loan from the Federal Housing Administration. In order to obtain the loan it was necessary for the corporation to issue to the Federal Housing Administration a valid special class of stock in consideration of payment to the corporation of an amount not exceeding $100. The corporation followed the usual procedure of issuing preferred stock to the Administration. Thus, while the purchasing corporation can acquire the entire issued and outstanding common stock of the corporation it cannot acquire the issued and outstanding preferred stock unless the loan is paid, which cannot be done due to lack of cash or ability to borrow the necessary funds. Will the inability to acquire the preferred stock result in the

purchasing corporation losing its classification as a real estate corporation?

In an Opinion of the Attorney General to the State Tax Commission, dated February 23, 1960, based on substantially similar facts as indicated above, it was held that the purchasing corporation will lose its classification as a real estate corporation since it will not acquire the entire capital stock of the other corporation. The opinion states: "There appears to me to be nothing unreasonable in construing the statutes as operating to confer certain benefits disjunctively rather than cumulatively—thus depriving the corporation of the benefit of Tax Law Section 182 if the corporation whose stock is acquired has chosen to secure an F.H.A. loan and in the process made compliance with Section 182 impossible." It is further stated: "As was said in *Terminals and Transportation Corporation* v. *State Tax Comm.*, 254 N. Y. 401, 404: 'We must take the Tax Law as we find it, and not attempt to adjust it to conditions which may not have been foreseen.'" Thus, the opinion indicates that the taxpayer in question (the purchasing corporation) is to be taxed under Article 9-A of the Tax Law rather than under Article 9.

The above opinion may seem to be harsh but appears to be following the decision of the courts in strictly construing the provisions of Section 182.

PERSONAL INCOME TAX— NONRESIDENT WITHHOLDING

One of our readers has advised us of the following matter involving the taxability of payments to nonresident employees subsequent to corporate dissolution.

A domestic corporation, in the process of liquidation, wished to acknowledge the loyalty of its former employees, all nonresidents of New York and heretofore subject to New York State income tax, and also to make some provision for their requirements subsequent to dismissal by the corporation. The corporation decided to make periodic payments to these former employees for a period of 36 months and, upon complete liquidation, to deposit the necessary funds in a bank account from which the payments would be made. The bank account would be under the jurisdiction of the corporation subject to any other disposition as determined by the corporation.

In view of the above, the following questions were presented to the Department of Taxation and Finance:

1. Are the payments made to the former employees (nonresidents) subsequent to their dismissal by the corporation subject to New York State income tax?

2. Is the corporation required to withhold income tax for remittance to the New York State Income Tax Bureau?

3. Is it possible to define such payments as pension payments and therefore nontaxable to the former employees, who were and continue to be nonresidents?

Our reader reports that the questions were answered as follows (in the order listed):

1. Dismissal payments to the former employees who are nonresidents are subject to New York State income tax to the extent based on prior personal services rendered in New York State.

2. The employer is required to deduct and withhold the proper amount of tax for remittance to the New York State Income Tax Bureau.

3. The payments described do not constitute a pension.

Accounting and the SEC

Conducted by Louis H. Rappaport, CPA

"SUBSTANTIAL" COMPLIANCE WITH SEC REQUIREMENTS

A few years ago the SEC introduced a new form of registration statement designated Form S-8. It was intended to be used in connection with employee savings and stock purchase plans which have been adopted by a number of large corporations—principally by those in the oil industry.

Because Form S-8 offers substantial possibilities for savings in time and effort as compared with Form S-1, issuers were quick to use the new form in situations where it was not intended to be used. The form had been used in a number of cases involving stock option plans when the SEC cracked down and forced registrants to use Form S-1.

More recently, however, the SEC has relented and has permitted Form S-8 to be used in connection with some employee stock option plans. Whether or not Form S-8 is available in a given case is a decision to be made by the issuer's attorney—not the accountant. But the accountant should be alert to the abbreviated financial requirements in S-8 mentioned below.

Insofar as it relates to financial statements, the requirements of Form S-8 are simple. The form calls for the following:

1. A summary of earnings covering at least five years, the last three of which must be certified (Item 11 of Form S-8).

2. Certified financial statements (without supporting schedules, however) covering the company's latest fiscal year included in its annual report to the SEC (Form 10-K, for example). If the annual report to the SEC includes consolidated statements, then such statements should be included in Form S-8, and the unconsolidated statements of the issuer omitted (Item 17 of Form S-8).

In certain circumstances the financial statements required by (2) above may be omitted in the prospectus which is part of Form S-8. The instructions provide in effect that if the issuer's published report to shareholders for its last fiscal year includes certified financial statements "substantially meeting the above requirements," such statements may be incorporated by reference in the prospectus. If the suggested procedure is applicable in a given instance, it means that the company must furnish a copy of the prospectus *and* a copy of its published annual report to employees or other persons to whom the offer is being made.

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As our readers know, the financial statements in an SEC filing must comply with the requirements in Regulation S-X. That regulation is not applicable to the financial statements in the ordinary published report to shareholders. Consequently the latter will not usually contain the notes to financial statements required by Regulation S-X. The regulation, for example, calls for a description of the company's depreciation policy, together with the rates used, if practicable. These and other notes must be furnished in an SEC filing but ordinarily are not included in published reports to shareholders.

It, therefore, becomes pertinent to inquire whether the statements in the published report "substantially" conform to the SEC's requirements in the light of the instructions in Form S-8. Would the published statements "substantially" meet the SEC's requirements if the so-called "compliance" notes were omitted? The answer—based on actual experience—is that, if the published statements meet the other principal requirements, the SEC does not object if the compliance notes are omitted and would accept the published report in these circumstances.

We know of a case where this question was recently considered by the SEC. A public utility company filed a registration statement on Form S-8 and included its published report to shareholders as a basic part of the financial presentation. The company is under the jurisdiction of a public utility commission which has promulgated a uniform system of accounts. The system requires that utilities subject to its jurisdiction include the reserve for depreciation on the liability side of the balance sheet, and not as a deduction from the related asset. This is directly contrary to Regulation S-X which (in Rule 3.11) provides that valuation reserves shall be deducted from the assets to which they apply.

In due course the SEC issued its memorandum of comments covering its review of the company's registration statement. The SEC said:

> Item 17 of Form S-8 provides that if the annual report of the issuer to its security holders for its last fiscal year includes certified financial statements substantially meeting the requirements of Regulation S-X, such statements may be incorporated by reference in the prospectus. In this connection, it is noted that the annual report to shareholders includes the reserve for depreciation under the caption "reserves and other credits" rather than as a deduction from utility plant contrary to the specific requirements of Regulation S-X and therefore would not meet the concept of "substantially meeting the requirements." However, this Division will raise no objection to the use of the annual report to shareholders provided the first paragraph under "Financial Statements and Summary of Earnings" on page 10 is expanded to include a discussion of the difference in accounting presentation of the above referred to item.

The registration statement was amended by the company by adding the following paragraph to the prospectus:

> The "Reserve for Depreciation of Utility Plant" is included under the caption "Reserves and Other Credits" in the balance sheet and has not been deducted from "Utility Plant" as required by regulations of the Securities and Exchange Commission. If the reserve were deducted from "Utility Plant" in accordance with such regulations, the net utility plant at the end of 19___ would be $__________.

Administration of A CPA Practice

Conducted by MAX BLOCK, CPA

BUILDING A GOOD STAFF

An accounting firm's growth, indeed its existence, is dependent on the quality of its staff. A good staff is not just an aggregation of accountants, nor is it an accident. It can result only from the knowledge of effective personnel management and development practices, and from constant, unremitting care and attention to them. These are the policies and practices that generally make for a good staff: (a) intelligent recruiting and selection; (b) good training and supervision; (c) high professional standards of practice; and (d) enlightened staff relations and management.

Each of the aforementioned, though a separate area of activity, nevertheless impinges on the others. In their application we might be guided by some of the tactics of great athletic coaches in the development of outstanding football, baseball and other teams.

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STAFF RECRUITING AND SELECTION

The sources of manpower need only be enumerated. They are public and private employment bureaus, college agencies, accounting school faculty, newspaper ads, own staff (recommendation of friends), and, in rare cases, fellow practitioners. Practitioners who enjoy good reputations in the profession are sought out by men who seek to improve their experience and status.

An interview is not to be treated casually. Good men are lost because of poor interview techniques and poor men are mistakenly employed. In an interview an applicant who has self-confidence and knows market conditions appraises his prospective employer critically and will not take the first job offered him. The applicant should be sold, truthfully, on the firm. Conversely, the interviewer must be able to raise proper questions, interpret the replies, gauge personality, and draw correct conclusions. Some interviewers use a check list to insure against oversights in questioning, and to jot down their observations so as to be able to develop a profile of the man for later review. Good selection, supported by good management, reduces turnover of personnel.

Aptitude and personality tests are an aid in the selection of personnel only if well understood by the person

giving the test and making the ratings. Otherwise they can result in the loss of good personnel and in unwitting harm to the rejected applicant. The American Institute of Certified Public Accountants has developed tests that have been used for years by many of the members.

A new man, of whatever rank or experience, must be carefully integrated. He just must not be "thrown into the pond to sink or swim." Integration means an explanation, by oral means and by staff manual, if available, of the firm's administrative and personnel policies. He should be shown around the office and introduced to everyone, including partners. He should spend a day or two in the office reviewing selected reports and working papers. He should be put at ease as quickly as possible. If the new man is to take charge of engagements he should be personally introduced to the clients' principals and accounting personnel.

GOOD TRAINING AND SUPERVISION

So much has been written on this subject, including comments in this department, that it needs only a most sketchy review.

Good training, which requires good supervision, is one of the uppermost considerations in a man's selection of the firm for which he will work. Some men will sacrifice compensation for a position where they will get good experience and can progress. What comprises good training and supervision? Basically, the following:

1. Observance by the firm of high standards in all areas of its practice.
2. Rotation of men on jobs.
3. "On the job" training programs.
4. "Off the job" training programs.
5. Good office reference library.
6. Circulation of required reading.
7. Required attendance at CPA Society technical sessions and other outside technical training.
8. Regularly scheduled discussions with men on their status and progress.

HIGH PROFESSIONAL STANDARDS OF PRACTICE

This is not a simple term to define. It perhaps can be comprehended by consideration of a list of the major elements that enter into high standards of practice, to wit:

1. Refusal to handle marginal clients and those whose accounting policies and procedures cannot be brought above a substandard level.
2. Insistence that annual and year-end audits be on a basis adequate for the expression of an unqualified opinion, except in meritorious cases.
3. The work of staff is carefully supervised on the job, papers and re-

ports are carefully reviewed on the job or at the office, and men are held to strict rules of accountability.

4. Audit programs, internal control questionnaires, permanent files, workpapers, financial statements, and other elements of the practice are carefully conceived, standardized, and strictly observed. A progressive attitude toward improvement is a collateral condition.

5. All of the physical aspects of financial reports, tax returns, special reports, letterheads, and other communication media should be dignified and of good quality.

6. Personnel management should be enlightened. Only the best men should be hired and they should be required to measure up to minimum cultural, educational, and physical appearance standards. Enlightened personnel policies will attract superior men and keep morale high.

7. Good service to clients and an unwillingness to compromise standards because of fee inadequacies.

8. Independence in all relations with clients.

9. Compliance with the rules of professional conduct of state and national CPA societies.

10. Good physical facilities and library.

ENLIGHTENED STAFF RELATIONS AND MANAGEMENT

This area is another that has been well covered in articles and by various dissertations in this department. For this reason only a cursory review is here deemed necessary. Moreover, because of the broad scope of this subject and its obvious nature it is here treated in outline form.

All of the elements that make for high professional standards of practice also enter into requirements for enlightened staff relations and management. The following are additional points:

1. Be slightly overstaffed rather than understaffed. The intelligent utilization of manpower makes for efficiency and high morale.

2. Keep overtime down to a tolerable level.

3. Be considerate of the status of married men and students in making out-of-town and overtime assignments.

4. Be considerate of travel time to and from home in making daily assignments.

5. Publicize, in a staff manual, administrative policies as to hours of work, travel and other expense reimbursements, overtime rules, vacation allowances, and other matters of interest to the staff.

6. Deal with the problem of poor staff men as soon as possible. This is not only good for the firm but also for the staff man.

7. Good supervision and staff training programs, including staff meetings and bulletins.

8. Intelligent, publicized opportunities for promotion.

9. Good compensation, with proper regard for outstanding competence: reasonable fringe benefit programs.

10. Regard for the comfort and dignity of men on the job and in the office.

11. Encouragement of specialization and continuing education.

12. Use of college trainees and eventual absorption into regular staff.

13. Careful integration of new men.

Payroll Tax Notes

Conducted by SAMUEL S. RESS, CPA

RECENT UNEMPLOYMENT INSURANCE DECISIONS

A decision handed down in June 1960 by a New York Unemployment Insurance Referee in Case No. E1295-59R held that an accounting firm was liable for unemployment insurance contributions on its payments to a "per diem" CPA. The latter had been engaged as an independent contractor rather than as an employee, for accounting and auditing services performed on behalf of the accounting firm on the books and records of the firm's clients.

This case has broad implications not only with respect to unemployment insurance but also as to state and federal withholding taxes, social security taxes and workmen's compensation and disability insurance, in the case of CPAs engaged on a per diem basis presumably as independent contractors rather than as employees. It may likewise affect the situation where correspondent certified public accountants are engaged by accounting firms to perform certain phases of an audit on behalf of the accounting firm.

Because of its general interest to members of the profession and since the decision is not generally available in the regular payroll tax services for perusal by practitioners, a full report of the Referee's Findings of Fact and Opinion is set forth below.

By determinations dated September 19, 1958 and November 28, 1958, the employer, who formerly conducted an accounting and auditing practice, was held subject to the unemployment insurance law, effective July 1, 1953, and liable for additional contributions in the sum of $2,010 for the audit period July 1, 1953 to June 30, 1958.

The employer concededly became subject to the law as of January 1, 1956, and whether he became liable for contributions as of July 1, 1953 depended upon the status of four certified public accountants who worked for the employer on a per diem basis. The status of a tax consultant who was not a certified public accountant was also in dispute. The Referee held that the four certified public accountants who performed professional services on a per diem basis were employees but the tax consultant who was not a certified public accountant, and was paid on a per job basis, was not an employee but an independent contractor.

Two of the CPAs, AB and CD, began their association with the em-

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ployer as salaried employees. However, as of July 1, 1953, they were no longer engaged as employees but were to render professional certified public accounting services on a per diem basis with no payroll tax deductions to be made from their earnings. No deductions were ever made from the earnings of the other two per diem CPAs or from the earnings of the tax consultant. During the audit period the four CPAs had their own practices but their own business was small and did not occupy them full time. Each CPA was, therefore, willing to work for the same employer to occupy his "dead" time. The arrangement which the employer made with each of the CPAs was that he was to be paid on an hourly basis. The employer kept time records of the hours that the CPAs worked and they billed the employer weekly.

The employer's practice consisted primarily of making monthly audits for his clients and each of the CPAs was accustomed to making the audit for the same clients each month. Since the CPAs were experienced and qualified and were familiar to a great extent with the client's business, they did not require close or detailed supervision. From time to time, however, it was necessary to consult with the employer. Occasionally he was present in person at the audit, and then he of course took charge. At frequent intervals the CPAs came to the employer's office to submit their work sheets, and report and receive future assignments.

Each of the CPAs dovetailed the employer's work with his own to reduce as much as possible any conflict as to scheduling. Once a CPA had accepted an assignment from the employer, he carried it out to the completion of the job. However, in making the audit, it was not essential that the work be done continuously and without interruption. It was usual for several of the CPAs to work together and only occasionally did they work alone. If they had to be absent a day the others would carry on. In each instance, however, the employer was advised as to the progress of the audit and notified if anyone was to be absent.

In addition to working at the establishments of the employer's clients, the CPAs spent some time at the employer's office. CD was associated with the employer for the longest time and she generally was regarded as the "senior" of the four CPAs. When she was in the office and the other girl was busy, CD would sometimes write some letters for the employer if requested to do so.

The four CPAs were paid for their transportation expenses. Those who used automobiles were paid a flat rate per mile. Those who used public transportation were paid for any sizeable amounts that they expended. Occasionally, they were paid for the meals they consumed.

The tax consultant EF, occasionally was engaged by the firm to analyze and plan an estate of an individual and do the tax research work that was involved. He was paid on an assignment basis and not on an hourly basis. He did the work as and when he chose and was not supervised, controlled or directed in the manner in which he performed his work.

The following quotation sets forth the Referee's conclusions and decision:

"It is my conclusion that the CPAs were employees, not independent contractors, because they were subject to the control, direction and supervision of the employer. They were given definite assignments, and while they are experienced CPAs and, to a

considerable extent knew what had to be done, nevertheless the employer acted as the overseer at all times. He was consulted during the course of the audit and kept a watchful eye on their services. He kept a record of the time that they spent on each audit, and they were paid, not by the job, but by the hours they spent on the work.

"The CPAs were reimbursed for their transportation expenses and occasionally for meals. Once they accepted an assignment they were not free to come and go as they pleased. They were expected to complete the audit, and while they were not necessarily required to work without interruption from start to finish, it is clear that the accountants felt obligated to complete the audit in as short a time as possible, working as continuously as they could.

"The relationship betwen the accountants and the employer cannot be governed by the label which the employer chose to attach to their association. The Division of Employment is not bound by the employer's election to treat the CPAs as independent contractors or the CPAs' willingness to be so regarded. The employer had the right to direct, control and supervise the CPAs and he exercised that right. Those engaged in professions can be employees. (*Parsons Sanitarium, Inc.*, 271 App. Div. 859, affirming Appeal Board, 12,630-46; *Tri-Reme Realty Corp.*, 296 NY 566, affirming Appeal Board, 10,778-44; *Philip Morganstein*, 274 App. Div. 866, affirming Appeal Board, 14,609-47.)

"The conclusion that the CPAs were employees and not independent contractors is fortified by the fact that when two of them were originally hired, they were treated as employees. When the employer ceased making deductions from their remuneration there was no change in the nature of their services or the amount of direction and control to which they were subjected. Only a bookkeeping change was made which, of course, cannot change the essence of their relationship.

"It seems to be the primary contention of the employer's estate that the CPAs were independent contractors because they worked for the employer part time and not full time. The Law makes no distinction between part-time and full-time employees insofar as coverage is concerned. (*Matter of Stotz*, 281 App. Div. 726, affirming Appeal Board, 28,839-51.) The test is direction, control and supervision, not the amount of time spent on the job. Here, there was sufficient direction and control to make them employees.

"EF was an independent contractor He was paid by the job, not by the hour. He was not directed or controlled as to the manner in which his services were rendered. The employer was only interested in the result. The difference between the relationship of the employer and EF and the employer and the CPAs is obvious. It follows that the sums paid to EF should be excluded from the audit.

"Decision: The determinations are modified to delete the sums paid to EF. Except for this modification, the determinations are sustained and the employer is liable accordingly."

Federal Taxation

Decisions and Rulings—BERNARD BARNETT, CPA
Guest Editor

Commentary —Committee on Federal Taxation
Chairman, ARTHUR J. DIXON, CPA

DECISIONS AND RULINGS

MEDICAL EXPENSES—TRAVEL AND LIVING COSTS

In 1956 the taxpayer, Mr. Carasso was stricken with a serious illness and underwent two emergency operations. On the advice of his doctor, he flew to Bermuda for further convalescence accompanied by his wife. Mr. Carasso's health was such that he could not have made the trip alone. His wife performed such services as might have been performed by a nurse. On his 1956 tax return Mr. Carasso deducted, as medical expenses, the cost of transportation to Bermuda for both his wife and himself. He also treated as medical expenses the cost of meals and lodging while in Bermuda. The Commissioner disallowed these costs. Mr. Carasso appealed to the Tax Court.

In a 1959 Tax Court case (*Bilder*, 33 TC 155) the Court had disallowed the transportation costs incurred by the taxpayer's wife who accompanied him to Florida pursuant to doctors' orders. There was no evidence that she had performed a nurse's duties. In its decision, the Tax Court judges noted that they could not conclude that having Mrs. Bilder with him in Florida was a part of the treatment of Mr. Bilder's serious heart disease. In Mr. Carasso's case, however, the Tax Court allowed the deduction of the transportation costs for both Mr. and Mrs. Carasso (*Carasso*, 6/29/60, 34 TC___ No. 65). As is true when a nurse accompanies a patient, Mrs. Carasso's presence and assistance were essential for his well-being.

With respect to the allowance of the patient's living expenses, however, Mr. Bilder came out ahead. The Tax Court found that his individual living expenses in Florida were proper medical deductions under Section 213. The Commissioner has stated that he does not acquiesce on this point. In Mr. Carasso's case, however, the Tax Court denied him a deduction for any of his meals and lodging in Bermuda. It based its decision on the

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ED. NOTE. Richard S. Helstein, CPA, will resume his regular editorship of this department with the November 1960 issue.

Congressional Committee Reports on the 1954 Code which, while specifically permitting a deduction for transportation of the patient, indicated that the cost of meals and lodging were no longer deductible except as part of a hospital bill. This Congressional intent was not even mentioned in the *Bilder* decision.

Suddenly, sixteen days after handing down the *Carasso* decision, the Tax Court withdrew for reconsideration its findings of fact and opinion. There has been speculation that the court may await the ruling on the appeal of the *Bilder* decision now pending before the Court of Appeals, Third Circuit. Unless it changes its opinion, the Tax Court in any new finding will presumably distinguish between the facts in these two apparently contradictory decisions with respect to deductibility of the patient's living costs.

RESTRICTED STOCK OPTIONS— DISQUALIFICATION NOT RETROACTIVE

Section 421 of the Code provides that the option price of a "restricted stock option" must be at least 85 percent of the market value of the stock at the time the option is granted. In order to make certain that an employee stock option meets the 85 percent test, some companies have included in the option agreement a provision that if the Internal Revenue Service should determine that the option price was less than 85 percent of the fair market value at the time the option was granted, the employee would pay the employer the additional amount necessary to satisfy the statutory requirements. Revenue Ruling 59-243, issued July 20, 1959, held that any plan containing such a provision which requires the Treasury Department to assume the function of making determinations of fair market value for the purpose of fixing the option price would not qualify as a "restricted stock option." Prior to the ruling many companies had included such a provision in option agreements acting in good faith.

The Service has now recognized that the retroactive application of Revenue Ruling 59-243 would result in undue hardship in such cases where the option would otherwise qualify but for such a price-redetermination provision. A new ruling (Revenue Ruling 60-242) cancels the retroactive effect of the prior ruling in the case of any option granted prior to July 20, 1959. The Commissioner states that such plans will not fail to qualify as "restricted stock options" solely because they contain such a provision.

REVISED INFORMAL CONFERENCE PROCEDURES

A taxpayer disagreeing with the findings of the agent examining his return normally receives a "10-day letter" offering him an informal conference with a conferee in the District Director's office. In the past, the designated conferee was often the agent's group chief. Some practitioners have questioned the utility of requesting such an informal conference with the examining agent's immediate superior who would normally uphold his subordinate's determination.

The Internal Revenue Service has recently revised its informal conference procedures with the announced objective of encouraging more taxpayers to avail themselves of informal conferences and the opportunity to settle unresolved differences, if possible, at the earliest audit level. Each district office is now provided with a full-time

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conference coordinator responsible for the direction and execution of the informal conference functions. Under the new procedures, taxpayers will have the opportunity to request that their conferences be heard by a conferee, appointed by the coordinator, who will hold the conference independent of the examining officer's group supervisor. This new procedure is to be followed not only in income tax cases but also with respect to estate, gift, excise and employment taxes. The Commissioner of Internal Revenue urges all taxpayers with unresolved differences to make full use of the new informal conference procedure. (Rev. Procedure 60-16.)

DEPRECIATION—USEFUL LIFE AND SALVAGE VALUE

In last month's issue this department reported the Supreme Court decisions in *Massey, Evans* and *Hertz* (Nos. 283, 141 and 143, 6/27/60) upholding the Government's position that the useful life to be used in computing depreciation was not the economic life of the asset but only the period it was actually used in the taxpayer's business. Massey, Evans and Hertz were in the automobile-renting business and it was held that their vehicles could only be depreciated over their useful business life of less than three years. In a case where the Commissioner argued the other side and used the four-year economic life as the determining factor, the result was substantial tax benefits to the taxpayer (*Hillard et al.* v. *Commissioner,* CA-5, 8/5/60).

Hillard also operated an automobile-rental business. In the years in question he suffered losses from rental operations but realized substantial gains from the sale of rental vehicles which had outlived their usefulness. These gains were treated as capital gains under Section 117(j) 1939 Code (now Section 1231 of the 1954 Code). Hillard originally depreciated the cars on the basis of a three-year useful life. The Commissioner determined that the vehicles should have been depreciated on a four-year basis. Hillard agreed to this change. The only issue to be resolved by the court was the determination of the Commissioner that the cars sold were not Section 117 (j) assets but constituted "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" and that therefore the gains on the sales constituted ordinary income.

After the *Massey, Evans* and *Hertz* decisions were handed down, the Commissioner filed a supplemental brief informing the court that he had adopted an incorrect theory of depreciation and that he should have based it on the three-year useful life in the taxpayer's business of leasing and renting cars. The Circuit Court, referring to the Supreme Court's decisions in *Massey,* etc., indicated that in this the Commissioner was correct but his discovery of his error came too late to permit any correction in the depreciation rate used. Turning to the point at issue, the court held that the automobiles were clearly not held primarily for sale to customers in the course of business and the gains realized were properly capital gains.

The Commissioner's four-year useful life determination resulted in a smaller depreciation deduction than that which Hillard had computed. Because of the large losses from rental operations which more than offset the disallowed depreciation, the disallowance resulted in no additional tax. However, the smaller depreciation allowed increased the adjusted basis of the cars sold and consequently decreased the amount of capital gains realized and the resulting tax. Hillard thus reaped benefits (and in amount

they were substantial), because the Commissioner took a view opposite to that which he took in the *Massey,* etc. decisions.

MISCELLANY

• Following the Commissioner's announcement that he will not follow the decision in *Bressner Radio, Inc.,* CA-2, 267 F. (2d) 520, noted in this department in May 1960, he has been given strong backing by the Seventh Circuit in *Streight Radio and Television, Inc.* v. *Commissioner,* CA-7, 7/28/60. In this case the Circuit Court of Appeals, affirming a Tax Court decision (33 TC 127), cited the Supreme Court's holding in the *Automobile Club of Michigan* case (*Automobile Club* v. *Comm.,* 353 US 180) and ruled that the amounts received by Streight on service and repair contracts were received under a claim of right, without restriction as to their disposition. As such, the entire amount received in each year is considered to be income. Streight's deferral of this income over the life of the service contract was struck down. Although the Seventh Circuit did not cite *Bressner* in its decision, the Tax Court had previously stated that it considered *Bressner* factually distinguishable.

• Costs incurred by a corporation in connection with the issuance of its capital stock in payment of a stock dividend are not deductible as ordinary and necessary business expenses but are capital expenditures. (Rev. Rul. 60-254.)

• Last year Congress amended Section 152(b)(2) to enlarge the definition of the term "dependent" by, in effect, waiving the requirement that a child reside as a member of a taxpayer's household for the entire taxable year if the child were placed with the taxpayer by an authorized agency for legal adoption. The Internal Revenue Service has now ruled that amounts paid by an adopting parent for medical services rendered directly to a child before its placement in the adopting parent's house constitute an allowable medical expense provided that (1) the child qualifies as a dependent of the adopting parent at the time the medical services were rendered or paid for; (2) the medical expenses are paid for the medical care of the particular child and are not paid merely as reimbursement for expenses incurred or paid by the agency prior to adoption negotiations; and (3) the adopting parent must clearly substantiate that any deduction claimed is directly attributable to the medical care of the child. (Rev. Rul. 60-255.)

• The Internal Revenue Service has ruled that legal expenses incurred to establish the fact that a municipal ordinance is not applicable to the taxpayer's business are deductible as ordinary and necessary business expenses. The ordinance prohibited the operation of certain businesses within the municipal limits. The question as to whether an expenditure is classifiable as a business expense or as a capital expenditure is one of fact. Costs which must be capitalized are not limited to the purchase of physical assets but include legal expenses incurred in defending or perfecting title to property. However, as in the facts set forth in the ruling, when the legal costs incurred were directly connected with the use and enjoyment of a business asset, rather than with its acquisition, replacement or improvement, the deduction of such expenses will be allowed. A previously issued ruling was modified to remove the implication that legal expenses incurred to protect the continued use of property for income-producing purposes are capital expenditures. (Rev. Rul. 60-261.)

COMMENTARY

DISTRIBUTION OF TAX REFUND CLAIMS IN SECTION 337 LIQUIDATION

Section 337 of the Internal Revenue Code of 1954 provides that no gain or loss shall be recognized to a corporation from the sale of certain property during the 12-month period beginning on the date of the adoption of a plan of complete liquidation if, among other conditions, all its assets (except those retained to meet claims) are distributed in complete liquidation during such 12-month period. The Regulations provide that, although assets may be retained after this 12-month period to meet claims (including unascertained or contingent liabilities or expenses), they must be specifically set apart for that purpose and must be reasonable in amount in relation to the items involved.

It is not unusual for a corporation which realizes large gains (not recognized under Section 337) to have a net operating loss in the taxable period ending with its complete liquidation. Such a loss may be attributable to one or more factors, for example, ordinary operations which are economically unprofitable, expenses incurred in liquidation, abandonments, or write-offs of items not previously deductible such as organization expenses incurred prior to 1954. Time pressures imposed by a 12-month liquidation, particularly when the corporation is disposing of real estate or machinery, may result in the failure to notice the existence of a current net operating loss. Apart from this, a corporation may have a tax refund claim other than one resulting from the carryback of a current net operating loss.

A claim for refund may often exceed the amount reasonably needed to meet claims. In such a case, distribution of the claim to stockholders or to a trust for their benefit is vital to enable the corporation to meet the complete liquidation requirement of Section 337. Failure to distribute the claim would result in the recognition of the gains realized on every asset sold by the corporation — a result which could be quite costly.

It is to be noted that under the statute prohibiting assignment of claims against the United States (31 U. S. C. Section 203) a corporation is unable to assign its claims for refund to a third party. Fortunately the courts have found, at least in other areas, that the transfer of a corporation's claims to its shareholders, as part of a complete liquidation, is not within the scope of the evils at which the prohibitions of the statute are directed, since there is no change in beneficial interests in the claim. See, for example, *Novo Trading Corp.* v. *Commissioner,* 113 F. (2d) 320 (2d Cir. 1940); *Kenney-Lindstrom Foundation, Inc.* v. *U. S.,* 60-2 USTC para. 9662 (D. C. Iowa 8/16/60). This rationale points to the conclusion that a tax claim should be assigned to all shareholders directly in proportion to their stock interests.

CHARITABLE DEDUCTIONS OF ESTATES

Section 642 (c) of the Internal Revenue Code specifies that an estate can take a deduction for a gift to charity only when made "pursuant to the terms of the governing instrument." Suppose that the decedent's will did not provide for a charitable gift or bequest, but that after the death of the decedent his estate continued for a limited period as a member of the partnership in which he had been a partner. During the taxable year in question, the partnership has made charitable contributions. May the

estate take a deduction on its fiduciary income tax return for its proportionate share of the charitable gifts made by the partnership in spite of Section 642 (c)?

This problem has been specifically considered in at least two Tax Court decisions — *Estate of Aaron Lowenstein,* 12 TC 694, affd. CA-5 (1950) and *Estate of A. Bluestein,* 15 TC 770 (1950). In its opinion in the *Lowenstein* case, the Tax Court gave its answer that "the charitable gifts were made not by the decedent's estate, but by the partnership as a business unit. . . . We think that the deduction should have been allowed to the decedent's estate as well as to the active partners. The fact is that the estate never received the amount representing its portion of the charitable gifts. They were deducted from partnership income before its share of the earnings was ever determined. . . ." The *Bluestein* decision also ruled that the deceased partner's estate could deduct its proportionate share of partnership contributions even though the decedent's will did not contain a charitable legacy or gift.

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DISTRIBUTION OF MONEY REQUIRED BY SUBCHAPTER S CORPORATIONS

In the July 1960 issue (p. 504), this department commented on the importance of timing the distributions by Subchapter S corporations.

A corporation which is not subject to Subchapter S can make a distribution out of earnings and profits in property, which includes money, securities, and indebtedness of the corporation. For a Subchapter S corporation, however, only distributions in money are deemed to be distributions of undistributed taxable income (of the current year) and distributions of previously taxed income (of prior years). (See Regulations Section 1.1373-1(h) and Section 1.1375-4.)

In the item referred to, the facts were as follows:

A Subchapter S corporation earned $30,000 in its fiscal year ended March 31, 1959 and $40,000 in the subsequent fiscal year. After the March 31, 1959 year-end audit had been completed it distributed the $30,000 profit to its stockholders on June 15, 1959. Accordingly, we pointed out that the stockholders were required to report $60,000 as income for 1959, under Regulations Section 1.1375-4. We indicated that if the $30,000 had been distributed between January 1, 1959 and March 31, 1959, inclusive, the stockholders would only have had to report $30,000 as income for 1959. The requirements for a distribution in money pose an interesting problem where the corporate activities during this period require the use of its working capital for inventory accumulation.

The issuance of notes of the corporation to its stockholders on or prior to March 31, 1959, payable in cash after March 31, 1959, will not be recognized as a distribution for this purpose according to Regulations Section 1.1373-1(d). To avoid the doubling

up of taxable income to the stockholders in 1959, the corporation must borrow the money to be distributed by March 31, 1959. The alternative is to avoid making any distributions to stockholders for the remainder of 1959. Either situation may create hardship. In the prior instance, the corporation's credit may not warrant further loans at regular interest rates. On the other hand, it appears to be unfair to stockholders to be required to wait until after the end of the calendar year to be able to withdraw the earnings of the Subchapter S corporation.

Since the requirement of distribution in money is in accordance with IRC Section 1373 (c), the Regulations are not at fault. To correct this apparently unintended hardship to stockholders, statutory changes may be required.

TAXABILITY OF PROCEEDS OF PENSION PLAN IN EVENT OF DEATH

If the entire proceeds of an employer-financed qualified pension plan are distributed to a named beneficiary of a deceased employee within one taxable year of such beneficiary, they are taxed at long-term capital gain rates. However, certain provisions of the Code permit exclusions in arriving at the amount to be taxed as a long-term gain. Section 101 (b) permits the first $5,000 of such proceeds to be excluded as an employee death benefit provided, of course, that there have been no other such death benefits which, in the aggregate, cannot exceed $5,000.

If the employer's contributions are invested with a life insurance company for the purchase of a retirement income, endowment or other life insurance contract for the employee, further amounts are excludable. Regulations Section 1.402 (a) (1) (a) provides for the elimination from the taxable amount of the portion of the premium attributable to the life insurance risk (which the employee has previously included in gross income), plus the portion of the life insurance attributable to the risk element.

The following example is to be found in Section 1.402(a)-1(a) (4) (iii) of the Regulations:

	$
Lump sum payable at date of death	25,000
Cash value of contract immediately before death	11,000
Excess over cash value, excludable under Section 101 (a)	14,000
Cash value subject to limited exclusion under Section 101 (b)	11,000
Death benefit excludable under Section 101 (b)	5,000
Balance taxable	6,000
Portion of premiums previously taxable to employee	940
Balance taxable as long-term capital gain	5,060

Section 2039 (c) provides for estate tax exemption on the entire amount, except the portion attributable to contributions of the decedent, provided the beneficiary is one other than the estate of the decedent.

The foregoing illustrates one of the benefits of a qualified pension plan. In the example given, out of a total death payment of $25,000, only $5,060 is taxable as a long-term capital gain, and the entire sum is exempt from estate tax.

EFFECT OF DEATH ON A COVENANT NOT TO COMPETE

Generally, where the purchaser of a business seeks to eliminate potential competition by the seller, and as part of the deal he obtains the seller's covenant not to enter into a competitive business for a definite period of time, the cost of such a covenant is deductible by him over the period of the non-compete agreement. To be de-

ductible it must be clearly identifiable with a definite value and must be distinguished from the purchase of the goodwill of the business which would be a non-deductible capital expenditure.

Where the covenantor dies during the period of the covenant, a problem arises as to the proper tax treatment of the unamortized portion of the cost. There do not seem to be any court decisions or rulings dealing with the problem.

Let us consider first the instance where there is a covenant not to compete for a ten-year period. Payment in full consideration for the covenant is made concurrently with the purchase of the business. The seller dies after three years have elapsed. Must the purchaser continue to amortize the balance over the original period or can he claim the entire amount as a deduction in the year in which death occurred? It would seem that the death of the seller has destroyed whatever value the asset possessed and, therefore, the unamortized amount can be deducted in the year of death.

Suppose instead of a complete payment in the year of purchase of the business, installment payments are made over the period of the restriction with the proviso that in the event of the death of the covenantor the payments are to continue for the remainder of the term but are payable to his widow or heirs. Under these facts it would seem that the correct treatment is to consider the contract as the acquisition of an amortizable intangible asset, with payment deferred, so that the unamortized balance should, as in the first example, be deductible in the year of death.

Is the circumstance of the covenantor's death (or the provision for this eventuality in the contract) any evidence that the agreement was actually a disguised disposition of goodwill? On this question, the following points should be considered:

1. Where the life expectancy of the restrained individual is greater than the period of the covenant, the fact that he died prior to the expiration of the term should not destroy the validity of the covenant even if he elected to receive these payments

in installments. He did not warrant that he would remain alive to the end of the term in order to insure that he received the entire amount for which he had bargained. Here death is the unexpected factor.

2. Similarly, the fact that the seller's life expectancy may be less than the term of the covenant should not cast doubt upon its validity. Practically all that the buyer is obtaining is a covenant for the term of the seller's life expectancy, but to insure himself against any possible adverse competition at the end of the life-expectancy period, he has sought assurances for a longer period of time. In this situation it may be proper for the covenant to be amortized over the life expectancy of the covenantor rather than over the period of the covenant since this would appear to represent the true intention of the parties.

GIFTS IN CONTEMPLATION OF DEATH MAY BE ADVANTAGEOUS

At times a person who is ill, particularly if he has reached an advanced age, will hesitate making a substantial gift under the impression that if he does die within three years, his estate will be adversely affected. He may assume this to be true because of the presumption contained in Section 2035 (b) that gifts made within three years prior to death were made in contemplation of death and as such are includible in the gross estate and subject to the federal estate tax. A closer examination of the problem will reveal that, on the contrary, the making of such a gift will often result in over-all estate tax savings.

Of course, if the donor does survive the statutory three-year period, the gift will only be subject to the normally lower gift tax and regardless of actual motive will be excluded from estate taxation. Section 2035 (b) specifically states that the contemplation-of-death rule is inapplicable to gifts made more than three years before the decedent's death. Where, however, the donor of the gift does die within three years after the date of gift, it still may be possible to successfully rebut the statutory presumption of contemplation of death. This may be effected by showing that the predominant reasons for the gift were motivated by contemplation of life (i.e., to save income taxes, etc.) rather than death. If the rebuttal is successful, the gift would only be subject to the gift tax and not to the estate tax.

Even where the gift is determined to have been made in contemplation of death, the making of such a gift would still normally have been advantageous. In such case, the donor's gross estate will, of course, include the property which was "gifted"—just as it would if the gift had not been made. The advantage in making the gift, however, lies in the exclusion of the gift tax from the taxable estate subject to estate tax. This will be true even if the gift tax had not been paid at the date of death. The gift tax liability would then be allowed as a deductible debt of the decedent in computing the taxable estate. This would reduce the estate tax. In addition, there is a credit allowed against the estate tax for the gift tax paid on a gift in contemplation of death included in the gross estate. There are, of course, certain limitations upon the gift tax credit (see Section 2012). Generally, however, all or most of the gift tax can be taken as a credit against the estate tax.

Therefore, as a result of the combination of the deduction and credit referred to above, a gift, though held to be in contemplation of death, will usually produce an over-all tax saving.

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CPA, over twenty years of diversified public accounting experience, has $8,000 gross and free time, seeks association with overburdened practitioner. Box 2140.

CPA, attorney, 38, own practice, seeks opportunity to put ability and experience to maximum use by association or partnership with single practitioner or firm. Cash available if required. Box 2141.

For Sale, used Multilith 80 and Gestetner 77-E reproducing machines, good condition, appointment call OX 7-0320.

CPA, highly qualified, $16,000 practice, 40% available time, seeks partnership, Nassau area preferred, will purchase interest if necessary. Box 2142.

CPA, MBA, 38, heavy public experience, available 50%, desires per diem arrangement leading to association or partnership, cash available. Box 2143.

CPA, 43, former revenue agent, self-sustaining practice past ten years, available time, seeks per diem arrangement leading to partnership. Box 2144.

For Rent, 44th St. east, attractive private office for CPA, or two share, sunny and newest lighting. YU 6-3075.

42 St. 11 W., light office to share, carpeted, furnished, Prentice Hall Service available, single practitioner, telephone answered, reasonable. Box 2149.

CPA, with fully equipped office, including complete tax library, Empire State Building, desires arrangement with individual practitioner to share secretarial service, men and space. Box 2150.

Office, private, midtown, in accountant's suite, air-conditioned, 2 windows, carpeted, approx. 10½′ x 12′. Will rent or exchange for services. WI 7-2345.

For Rent, 475 Fifth Ave., air-conditioned private office, in CPA suite, or share furnished, secretarial space available. MU 5-0663.

Wall Street, one large air-conditioned room available immediately in attorney's suite, HAnover 2-0448.

CPA, attorney, AICPA, NYSSCPA, modest practice, seeks association or per diem arrangement with practitioner planning retirement, reduced activity. Box 2152.

For Rent, air-conditioned office in CPA firm midtown suite to individual CPA interested in sharing some personnel and office services with view toward possible future association. Box 2153.

CPA, has space in midtown suite, air-conditioned, beautiful decor, object sharing staff facilities and other mutual benefits leading to possible merger. Box 2154.

CPA, modest practice, seeks association or per diem arrangement with practitioner planning retirement. Box 2155.

CPA, modest practice, will service accounts on per diem basis, ultimate aim purchase of accounts. Box 2156.

CPA, Society member, modest practice, will buy entire practice, individual accounts, or other arrangements for mutual convenience. Box 2157.

Wanted, midtown area two private offices or one large office. Will share portion of office services. CPA firm. Box 2160.

CPA, attorney, Sabbath-observer, own firm, seeks for growth an associate with own practice to explore partnership possibility. Box 2162.

CPA, 35, seeks association with overburdened or retirement conscious practitioner; desires to purchase or manage practice or individual accounts. Box 2163.

CPA, 42, medium size practice, seeks partnership with established firm, substantial capital available. Box 2167.

Accountants Service Center offers a place to keep things, obtain phone answering service, receive mail, meet a client, do tax research, get reports typed and other chores handled in exchange for an economical sum. Cost can be as low as $5 a month. A whole floor of office and desk spaces at 120 Liberty Street, BArclay 7-5816.

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